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We are fortunate in being able to present to you in this issue an article on fiduciary accounting by Ethleen Lasseter. As trust auditor of The First National Bank of Atlanta, Georgia, and formerly as manager of trust operations, she has had extensive experience in fiduciary work.

This article presents a general discussion of some of the problems involved in accounting for trusts and estates and should be of interest to accountants, bankers and all others who deal with fiduciary matters. It will guide readers to points in their own state laws which should be checked in handling trusts and estates, as well as points which should be adequately covered in drawing wills and trust instruments in order that the real intent of the testator may be carried out.

Miss Lasseter has contributed previously to "The Woman C.P.A." and was at one time its editor. She is a past president of AWSCPA and has served both our societies notably and continuously. Her articles on banking and allied subjects have been widely printed. In 1945 she was chosen as Atlanta's Woman of the Year in Business.

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ACCOUNTING FOR TRUSTS AND ESTATES

By ETHLEEN LASSETER, C.P.A.

Accounting for trusts and estates is largely a matter of apportioning receipts and disbursements between principal and income. Usually, especially in the larger estates, the residue, or what remains of the gross estate after settlement of debts, claims, bequests, estate taxes and administrative expenses, is left in trust with the income therefrom payable to one class of beneficiaries, commonly referred to as life tenants, and the principal, or corpus, distributable at the death of the life tenant, or at some other designated time, to another class of beneficiaries, commonly referred to as remaindermen.

Consequently, there are two distinct classes of beneficiaries whose separate interests may be properly and impartially served only through proper apportionment between principal and income. The problems involved are many and complex.

Some of the problems arise through improperly drawn instruments. Frequently, wills and trust instruments are silent on a number of important points; or, worse still, contain ambiguous language and conflicting provisions. Problems arise also through inadequate state laws. Fiduciary laws in some states are absolutely silent on apportionment. Therefore, the fiduciary, who may be an individual or a corporation and who may be acting as executor, administrator, trustee or guardian, must rely frequently upon judgment and discretion in determining the real intent of the testator which is the controlling factor in making apportionment between principal and income. Since the effects may extend generations into the future, extreme caution must be used and, in some instances, it is necessary to petition the Court for direction.

There are two concepts regarding trust administration which should be recognized in any study of accounting for trusts and estates. When the testator who executed the will or trust instrument bequeaths the income from the residue of his estate to a life tenant, his intent is that the life tenant enjoy, as nearly as possible, the same income from these assets that he, the testator, had enjoyed during his lifetime. Also, the life tenant is the primary beneficiary and his interest or welfare, in the absence of specific provisions to the contrary, is the first consideration of the testator.

Those two concepts have long been reflected in legal interpretations of wills and trust instruments, and in court decisions on fiduciary matters. They have also had a pronounced influence upon the exercise of judgment and discretion by fiduciaries. They are reflected too in the Uniform Principal and Income Act which has been adopted with some modifications by 16

states, the widely influential Massachusetts Rule, and in the general practices and policies of fiduciaries in states which do not have adequate laws on apportionment. It is not surprising then to find in frequent instances that apportionment properly made from an administrative standpoint does not conform to the accounting principles applied in making apportionments for other purposes.

Accrued Income

In estates the first occasion for apportionment is usually in determining what income was accrued at the date of death of the testator, since the corpus of an estate consists not only of property owned by the decedent but also any income accrued on the date of his death. The fact that the items are taxable as income when received does not necessarily make them income in fiduciary accounting. Ledgers and records necessarily are designed to reflect the separate interests of the two classes of beneficiaries.

Accrued interest on bonds is merely a mathematical computation. Stocks held on date of death must be traced to an investment service, or other reliable source, for possible accrued dividends. From the standpoint of the paying corporation, dividends accrue on the date declared, but they accrue to stockholders on the date of record specified by the corporation as the date on which stockholders entitled thereto are determined. Proceeds of interest coupons may be part principal and part income, but a dividend is either principal or income in its entire amount.

Ordinarily rents are payable in advance. In the event the date of death is February 2 and rent due February 1 is unpaid, rent for the entire month of February is accrued on the date of death.

In accruing interest on notes, consideration must be given to the fact that sometimes interest is included in the face amount, in which event a portion of the face amount must be apportioned between income and principal. Distinction may be reflected on ledgers by recording as face amount the total amount payable, and as inventory value that portion of the amount payable that is to be credited to principal cash upon receipt of payment.

Since professional men customarily file their tax returns on a cash basis, accounts receivable in their estates, though taxable as income when collected, are accrued income on date of death, and the proceeds become principal in estate accounting.

Accruing income at date of death presents especially complex problems in the matter of crops growing in fields, and fruit on trees. Values placed on them by appraisers acceptable to the Internal Revenue Department for estate tax purposes usually may be used in estate accounting also.

Interesting situations arise in that respect in connection with orange groves as it is not unlikely that three crops will be involved. In one instance, an estate was comprised largely of a valuable orange grove. On date of death, one crop was in process of being harvested, the next crop was considered by appraisers to be set and therefore to have a salable value at that time, while the third crop was in blossom.

Accrued income with respect to the first crop was determined from records of the growers association which reflected exactly how many boxes had been gathered before date of death and how many were gathered after date of death. The second crop, which was appraised as having a value of $9,300 on date of death, finally netted $11,000, of which $9,300 became principal and the balance income.

The matter of accruing income is involved also in the event of the death of an income beneficiary entitled to income from the trust for the duration of his or her lifetime; also, in making final distribution in proper proportions to two or more remaindermen.

Expenses prepaid by decedents or trustees ordinarily are not deferred as of date of death, or date of distribution.

Amortization

Amortization of bond premiums and discounts is another item of importance in apportionment between principal and income. The Massachusetts rule, Uniform Principal and Income Act, and fiduciary laws of some states which have not adopted the Uniform Act, provide that the entire amount of interest received shall be treated as income distributable to life tenants, and that any loss or gain realized upon maturity or other disposition, shall fall upon or inure to principal, or remaindermen. That procedure is based largely on the need for some clear, intelligible and workable rule for the treatment of amortization.

In the absence of specific provisions or state law to the contrary, the policy of fiduciaries in regard to amortization in some states is based more on logic, and less on practicality from an operating

standpoint. Premiums on bonds which constituted part of the original inventory are not amortized, following the general concept of trust administration. Premiums on bonds purchased by fiduciaries as investments for trusts are amortized, the theory being that the original estate should be kept intact for remaindermen as nearly as possible and over a period of years premiums on bonds purchased could make considerable inroad on corpus. While not amortizing original inventory items will cause some inroad on corpus, it will result from investments made by the testator, not the fiduciary.

It is paradoxical that policies based on such fine points of logic often lead to complications which necessitate exceptions to rules, and emphasize the need for practicality. In perpetual trusts all premiums may be amortized, whether bonds are original inventory items or purchases, as it is considered that there is a sacred trust to preserve the corpus which quite conceivably over a period of years could be exhausted completely through unamortized bond premiums. In other trusts amortizing premiums would only necessitate useless ledger entries, as is the case with trusts which provide encroachments, or invasion of corpus, for the benefit of life tenants, if encroachments are likely to exceed any possible total of bond premiums. Then, too, in some trusts amortization is prohibited through provisions of the instrument.

There are two other lines of reasoning regarding amortization which are significant. If the remaindermen sustain some loss through premiums not being amortized, it may still be to their advantage as the type of bond that sells at a premium is usually the safest form of investment and thereby a protection to the remaindermen's ultimate inheritance. If life tenants seem to sustain some loss through premiums being amortized, it is not actually the case. In effect, premiums and discounts are merely a means of adjusting interest rates on bonds previously issued to the market price current at the date of purchase.

Customarily, bond discount is not accumulated.

Stock Dividends and Rights

Apportionment between principal and income becomes even more complex with stock dividends, which may be paid in stock of the issuing corporation or of another corporation; also, rights issued, which may be to acquire additional stock in the issuing corporation, or in another corporation. The same problems are involved in extraordinary cash dividends paid from earned surplus, which may have been earned prior to, or subsequent to, acquisition of the stock; or from proceeds of the sale of capital assets, which is usual with shares in investment trusts. Even ordinary dividends paid from current earnings present problems when depletion or depreciation is of relative importance and, as a result, a significant portion of the dividend is non-taxable.

The Uniform Principal and Income Act provides that all dividends paid in cash, regardless of the source of the funds, shall be income and all dividends paid in stock of the declaring corporation shall be principal; dividends payable in cash or stock at the option of the stockholder, shall be income regardless of the election made; rights shall be principal if they convey the right to acquire additional stock in the issuing corporation and income if to acquire stock in another corporation.

When neither bound nor guided by state law, fiduciaries generally follow somewhat the same policies, giving individual consideration, however, to peculiar circumstances which frequently alter cases.

Distributions

Distribution of income too, as well as receipt, involves many complex problems. One of the most difficult is the determination of what income is distributable to a widow, for example, who is entitled to the net income on the residue on her husband's estate from the date of death. Net residue may be ascertained only through the determination of the estate tax liability, administrative expenses, debts of the decedent, specific bequests, and all other items chargeable against the general estate. Since the laws of most states allow creditors one year in which to file claims against estates, and the Federal Tax law allows the fiduciary 15 months from date of death in which to file the Estate Tax Return, one year is usually the minimum time in which the exact residue of an estate may be determined, and it may be as much as three years or more. Yet, it is obviously the intent of the testator that his wife be provided with means of support from the date of his death. Therefore it is necessary for the executors to estimate early in the life of estates approximately how much cash will be required and what items will likely be sold to raise the necessary amount. Income on

those items should be withheld by the Executor, and the remainder distributed. In the absence of any provisions or specific law to the contrary, this is essential in order to protect fiduciaries from possible later claims by remaindermen, who eventually will be entitled to receive the residue. At the same time, it may appear to conflict with the general concept that life tenants have a superior equity in the estate over the remaindermen.

Strange to say, The Uniform Principal and Income Act contains no provisions covering this point. The Massachusetts Rule, however, provides that the entire income, under those circumstances, be distributed to life tenants. Certainly, administration of estates would be less complex if income accruing from date of death on all property not specifically bequeathed could be considered as being distributable to life tenants.

A change in the Federal Revenue Act of 1942 created another difficult problem in distributions. Many wills executed prior to the effective date of that act provided that income be accumulated and added to corpus, and that the widow, or other life tenants, receive annuities of stipulated amounts. Income then was taxable to the fiduciary, and the annuities tax free to the recipients. Under the Federal Revenue Act of 1942 such annuities are taxable to the beneficiary, rather than to the fiduciary, in so far as the funds from which the annuities are paid arise from taxable income. That poses the question as to whether beneficiaries are entitled to the amount of the stipulated annuities, over and above the taxes due thereon. If the will provided that the widow receive an annuity of $10,000, she now would be enjoying the benefit of approximately $7,700, granting that she had no further income and only one exemption.

One decision has been rendered by a New Jersey court awarding a beneficiary an additional amount annually to cover income tax not foreseen by the testator at the time the will was executed. A Delaware court has rendered an opinion that a beneficiary to whom an annuity of $6,000 was bequeathed under similar circumstances, was to receive only $6,000 in spite of the Federal Revenue Act of 1942, even though the will provided for the payment by the trustee of all charges, "including taxes levied or finally assessed."

If the widow who is paying the income tax on her $10,000 annuity is satisfied, it might be considered that all is well. The fiduciary, however, must be ever mindful of what his position would be if sometime later, as executor under the widow's will, he should be charged with the responsibility of collecting all amounts due her estate. Such situations, which frequently arise in various phases of trust accounting, present the supreme test of impartiality in justly serving the separate interests of life tenants and remaindermen.

Real Estate

Real estate presents a variety of problems. The most difficult perhaps arises on the sale of real estate of considerable value which had been non-productive or had been operated at a loss for a period of time. The life tenant naturally feels that he is entitled to a portion of the proceeds of the sale to offset his loss in income. Usually in such cases the fiduciary petitions the Court for direction in making any apportionment of proceeds between principal and income.

Customarily net income distributable to life tenants is determined without regard for depreciation. That policy favors life tenants through not only an increase in income distributable to them but also a decrease in the amount of income taxable to them by reason of the allowable depreciation. They may even claim the allowable depreciation on their personal income tax returns even though actually there was no distributable income because of operating losses. Irrespective of the obvious disadvantage to remaindermen, the policy has been upheld by the highest courts and has become established practice.

Conclusion

There is no end to the number or variety of the problems involved in accounting for trusts and estates. Limitation of space precludes even mere mention of many of extreme importance. The foregoing discussion, however, illustrates some of the fine points involved and the different angles from which they must be considered.

SUCCESSFUL CANDIDATES

Congratulations to the following Ohioans who have passed the CPA examinations: Suzanne Adams, 129 W. Streicher St., Toledo; Mrs. Lillian Widmaier, 1307 Parsons Ave., Columbus; Mrs. Josephine Skodis, 541 East 123rd St., Cleveland. All are members of ASWA.