THE ROLE ACCOUNTANTS PLAY IN ESTATE PLANNING

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Estate planning

People commonly make plans for the orderly transfer of their property upon their death to relatives other persons, organizations, or trusts to be set up for the benefit of relatives. Such forethought is known as estate planning and is accomplished under the guidance of attorneys, often working closely with accountants. The attorney's role centers around preparing wills and, in many cases, trust agreements (discussed in detail later in the chapter). The accountant's role consists of suggesting planning techniques consistent with the objective of minimizing transfer costs (federal estate taxes, state inheritance taxes, and fees and expenses). In this capacity, an accountant often determines expected transfer costs under various options. An accountant may also play an important role in advising his or her client on accounting matters pertaining to trusts that are to be established.

Accountants' participation in estate planning is usually limited to cases in which individuals are wealthy or moderately wealthy. Under current law, roughly 99.5% of all estates are exempt from estate and gift tax laws. An accountant participating in estate planning must have substantial expertise in estate and gift taxes—a complex area of the tax laws. A detailed discussion of these laws and the use of planning techniques to minimize transfer costs is properly the subject matter of a tax course.

The Trust Feature of Estate Planning

Frequently, a will contains a provision for the establishment of a trust, whereby certain designated property of the decedent's estate is to be transferred to a trustee when the person dies._ The trustee holds legal title to the property and administers it for the benefit of one or more other persons, who are called beneficiaries. Thus the trustee serves in a position of trust with respect to the beneficiaries. This is a fiduciary relationship, and the trustee is commonly referred to as a fiduciary. The person creating the trust is referred to as the trustor (also known as the grantor, donor, creator, and settlor). The legal document creating the trust is the trust agreement. Trust beneficiaries are of the following two classes:

1. Income beneficiary. An income beneficiary is entitled to the income earned by the trust's assets, referred to as the trust principal, or corpus.
2. Principal beneficiary. A principal beneficiary is entitled to the principal, or corpus, of the trust, which is distributed according to the terms of the trust agreement (usually at the specified termination date of the trust). A principal beneficiary is also known as a residuary beneficiary or remainderman.

The income and principal beneficiaries may or may not be the same person. A common arrangement is to name one's spouse as the income beneficiary for his or her

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remaining life and name one's children as the principal beneficiaries. Another common arrangement is to name one's children as both income and principal beneficiaries, with some or all of the income to be used for their support and the principal to be distributed to them when they reach a specified age.

The Basic Accounting Problem

Regardless of whether the income or principal beneficiaries of a trust are the same person or persons, it is necessary to account for the separate interests of each class. Accomplishing this task is the subject of this chapter. The requirement of correct separate accounting for the interests of each class is the reason for the special theories and techniques for accounting for the administration of estates and trusts by fiduciaries. Otherwise, quite simple record-keeping procedures are adequate.

Accounting for the separate interests of each class of beneficiaries is even more difficult because a built-in clash of interests exists between the two classes. When the principal and income beneficiaries are not the same person or persons, the clash revolves around who gets what. When the principal and income beneficiaries are the same person or persons, the clash concerns the timing of distributions. Frequently, disputes between these interests lead to litigation.

Although a trust may be established by a transfer of property to the trustee during the transferor's lifetime (known as an inter vivos trust), we deal solely with trusts that are created by a gift made in the will of a decedent (known us a testamentary trust). Thus we must consider the administration of a decedent's estate in connection with the establishment of a trust.

The Accounting View

For accounting purposes, we treat the estate and the trust as separate accounting entities Further more, we conceptually view each of these separate accounting entities as composing two accounting entities: a "principal entity" and an "income entity." Thus, conceptually, four accounting entities exist.

The Tax View

For tax-reporting purposes, estates and trusts both are treated as taxable entities. They are not legal entities, however, in the sense that corporations are legal entities.

2. Principal versus Income

When a testamentary trust is established, every transaction must be analyzed to determine whether it relates to principal or income. An incorrect determination has important legal consequences to a fiduciary. If it is later determined that income has been overstated and the fiduciary cannot recover the amount of the overpayment from the income beneficiary, the fiduciary must make up the deficiency. In turn, if the error was made by the accountant or was based on the bad advice of the fiduciary's legal counsel, these persons may be professionally responsible to the fiduciary.

Manner of Analyzing Transactions
Reference to the Trust Agreement

In determining whether a transaction pertains to principal or income, GAAP is not the point of reference. The trustor may create his or her own definition of income. In other words, the trustor may specify the receipts that are to be income and the receipts that are to be principal. Likewise, the trustor may specify disbursements to be treated as charges against income disbursements to be treated as reductions of the principal. Accordingly, all transactions must be analyzed as to the decent's intent.

Because the decedent is not available, the first step is to determine whether the decedent's intent is expressed in the trust agreement. Unfortunately, a common shortcoming of estate planning is that trust agreements usually do not explain in detail the treatment to be accorded specific types of receipts and disbursements. Many potential problems can be avoided if the decedent's personal accountant, who should have a knowledge of his or her client's properties, participates in the preparation of the trust agreement sections that pertain to accounting matters.

Reference to State Law

If the treatment of an item *cannot* be resolved by referring to the trust agreement, the *second step* is to find out what the *state law* is on the subject. Again, GAAP is *not* the point of reference. The Revised Uniform Principal and Income Act specifically addresses the principal versus income treatment of several items. Much of the impetus for revising the original Uniform Principal and Income Act (of 1931) resulted from the development of new forms of investment property, the treatment of which was not specified in state statutes. The treatment accorded many items specifically dealt with in the act produces income results that would be obtained if GAAP is applied. For numerous other items, however, the treatment produces results that are quite contrary to GAAP. For example, the act provides that the following items be treated as increases and decreases, respectively, to the trust principal—not the trust income:

1. Gains and losses on the sale of corporate securities.
2. Gains and losses on the sale of rental property.
3. Bond discounts (with certain exceptions) and bond premiums.

Reference to Case Law

If the treatment of an item is not covered in state law, the third step is to determine whether the courts have encountered and ruled on the same problem. If so, the answer is found in case law. If the answer cannot be found there, the fiduciary may petition the court for a determination.

The Accountant's Role in Analyzing Transactions

When the treatment to be accorded an item is not clearly set forth in the trust agreement or state statutes, the accountant does not determine whether an item pertains to principal or income. This is the function of the fiduciary, the fiduciary's legal counsel, or the courts. The accountant's role is expanded, of course, when the trust agreement specifies that income is to be determined in accordance with GAAP. Such cases, however, are the exception—not the rule.

Manner of Record Keeping

Because the interests of the principal beneficiary and the income beneficiary must be accounted for separately, it is necessary to identify the assets and transactions pertaining to principal and those pertaining to income. Conceptually, we may view the assets and transactions pertaining to principal as belonging to a separate accounting entity and do likewise for the assets and transactions pertaining to income.

One method of record keeping is to physically maintain separate journals and general ledgers for each accounting entity. An alternate method is to use one set of books for both entities but to use separately identified columns in the journals and separately identified accounts in the general ledger for principal and income. This technique allows separate trial balances to be prepared for each accounting entity, as though two general ledgers were used. In practice, this technique is quite simple to work with, largely because cash is usually the only type of asset common to both principal and income.

Cash Basis versus Accrual Basis At the Beginning and the End of the Income Beneficiary's Rights

In most respects, the Revised Uniform Principal and Income Act provides for the use of the *accrual basis* in determining at the time of the person's death the assets to be treated as part of the trust *principal.* The purpose, of course, is to establish a reasonably fair and practical starting point to determine income for the *income* beneficiary. Specifically, the following items are to be included as part of the trust *principal* at the time of death:

1. Amounts due but not paid at the time of death.
2. Prorations of amounts not due at the time of death that pertain to periodic payments, including rents, interest, and annuities.
3. Corporate distributions declared for which the date of record precedes the person's death.

The cash basis is specified for all other items. In a somewhat parallel manner, the act provides in most respects for the use of the accrual basis on termination of an income interest to effect a reasonably fair and practical cutoff of the income beneficiary's interest.

Accounting Periods between the Beginning and the End of the Income Beneficiary's Rights

For accounting periods between the beginning and the end of the income beneficiary's rights, the accrual basis in most respects does not fit in with the underlying objective of the fiduciary, which is to account for the flow of assets in and out of his or her control. Accordingly, with one major exception, the cash basis is considered more appropriate for such accounting periods. The accrual basis offers much better measuring results, however, when determining the income of a business in which principal is invested.

At the End of the Estate Administration

When the income rights of the income beneficiary are established at the time of the person's death he end of the estate administration is not relevant to the income and principal beneficiaries. Using the accrual basis is therefore unnecessary at the end of probate administration. Of course if the trust agreement provides that income rights do not start until the end of the estate administration,

accrual techniques are appropriate..

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