

# A PRIMER ON THE UNIFORM PRINCIPAL AND INCOME ACT: HOW ACCOUNTING AFFECTS TRUST AND ESTATE BENEFICIARIES

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DAVID KEENE PROVIDES A PRIMER ON HOW ACCOUNTING AFFECTS TRUST AND ESTATE BENEFICIARIES UNDER THE UPIA.

I have had an interest in writing about issues on the accounting for estates and trusts, especially the income/principal distinction which is articulated in the Uniform Principal and Income Act (UPIA) adopted by most states. After all, this income versus principal distinction assists in answering the “who gets what” question as to the economic benefits a trust or estate will be providing its beneficiaries—something in which the beneficiaries and their advisers should be keenly interested.

A number of UPIA topics, each worthy of an article, come to mind. The problem is that any one aspect of UPIA will, by definition, have limited utility. More importantly, the broader subject of how UPIA works only can be touched upon in an article devoted to, for instance, depreciation under UPIA. And more often than not it is these underlying concepts that are the stumbling block for practitioners

struggling with a particular UPIA issue. For this reason, this article is devoted to UPIA’s concepts and underlying principles.

In many states, a revised version of UPIA (RUPIA 1997) has replaced the first revision (RUPIA 1962<sup>1</sup>) or the original 1931 law (UPIA 1931). RUPIA 1997 maintained many of the basic rules and principles of RUPIA 1962, though some significant changes were incorporated in the newer uniform law. Understanding how these changes may affect trust and estate clients’ situations will be valuable to advisers. Accordingly, many of these significant changes will be discussed. Further, some less universal changes included in the new law will be examined in future articles focusing on various aspects of UPIA.

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## What Is UPIA About?

It is sometimes said that UPIA governs the accounting for trusts and estates. This statement is overly broad and, as such, it can be misleading: UPIA is for the most part confined to a particular aspect of trust and estate accounting. That aspect is the determination of *what is income* versus *what is principal* for the receipts and disbursements of a trust or estate.<sup>2</sup>

This income versus principal determination flows from a distinctive characteristic of trusts and estates. These entities have two classes of owners; those that have an interest in the entity's income (income beneficiaries) and those having an interest in the principal (principal beneficiaries). Stated in accounting terminology, trusts and estates have two different equity interests—income and principal. Accordingly, the (UPIA) rules governing how a receipt or disbursement is to be categorized (principal versus income) will determine which equity interest holder is to receive the benefit of any receipt or whose interest will be reduced by a disbursement. This naturally creates a conflict: If a receipt is determined to be income, the income beneficiary (*a.k.a.*, equity interest holder) will benefit to the detriment of the principal beneficiary, and vice versa. Therefore, beneficiaries will likely be sensitive to the fiduciary's determinations of income versus principal.

Before moving on, let us agree on some terminology. There are three existing versions of UPIA: the original 1931 statute and its progeny, the 1962 revised statute and the most recent 1997 revised

act. Some states now have the original 1931 law; others have either the 1962 or 1997 revision. There are characteristics all three have in common, as well as differences. UPIA will be the acronym describing universal principles; used in those cases where all three laws share traits in common. Correspondingly, UPIA 1931 will be used to refer specifically to the original law, and RUIA to refer to both the 1962 and 1997 revised statutes. And, of course, RUIA 1962 or RUIA 1997 is meant to refer to these individual laws.

## A Basic Example

Let us look at the financial information of a trust, and by doing so, examine how UPIA's income/principal classification rules affect the rights of beneficiaries. Specifically, let us look at how these rules play an important role in answering the "who gets what" question. Please refer to Illustration 1.

In order to focus the attention on the UPIA issues in this example, the presentation has been streamlined. The relevant terms of the trust in this example are as follows:

### ILLUSTRATION 1

#### SMITH MARITAL TRUST CHARGE AND DISCHARGE STATEMENT—INCOME TAX BASIS FOR THE YEAR ENDED DECEMBER 31, 2001

<b>Principal</b>	
The Trustee charges himself with:	
Beginning principal balance	\$3,821,160
Gain/(loss) on sale of securities - Schedule A	82,138
The Trustee credits himself with:	
Accounting fees	(2,474)
Income tax expense	(28,179)
Administrative fees	(15,650)
	<u>(46,303)</u>
Balance before distributions	3,856,995
Distributions to Jane Smith	<u>(214,125)</u>
Leaving a principal balance of	<u>3,642,870</u>
<b>Income</b>	
The Trustee charges himself with:	
Interest income, Schedule B	269,971
Dividend income	<u>10,298</u>
	280,269
The Trustee credits himself with:	
Accounting fees	(2,474)
Administrative fees	(15,650)
Foreign tax expense	<u>(710)</u>
	<u>(18,834)</u>
Balance before distributions	261,435
Distributions to Jane Smith	<u>(261,435)</u>
Leaving an income balance of	<u><u>\$0</u></u>

- Income must be distributed annually to the trust's only income beneficiary, Jane Smith.
- The principal beneficiaries of the trust are John and Bill Smith (children of Jane), who are to receive equal shares of principal following Jane's death, and Jane, who is to receive five percent of the trust principal annually.

In Illustration 1, notice that this charge and discharge statement presents two reports—one on the principal (equity) account, the other on the income (equity) account.

The report on principal starts with the beginning of the year balance and then reflects additions and reductions occurring during the year to arrive at the balance before distributions. These additions and reductions reflect the same type of information one sees in the income statement of a commercial enterprise, and that is exactly what this is—the income statement of the trust's principal equity account. The remaining information—the distributions from principal and year-end balance in the principal account—complete the report on the principal equity account.

The report on income contains the same sorts of information and follows the same format as the principal report of the charge discharge statement. Put into perspective, what is shown are two income statements: the *principal-income* statement and *income-income* statement, one could say, and the distributions from each account to arrive at the year-end balance for these two equity accounts.

Overall, the illustration shows how the income/principal determinations (in conjunction with the distribution provisions of the trust agreement) affect what each beneficiary is to receive. Such determinations are governed by UPIA.

## What Is Principal and What Is Income?

UPIA 1931 as well as RUIA 1962 and RUIA 1997 provide similar definitions of principal and income. (However, beyond these basic definitions, the specifics of these laws differ.) The most current laws define *principal* as follows.

- **RUIA 1962.** Principal is the property which has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman while the return or use of the principal is in the meantime taken or received by or held for accumulation for an income beneficiary ...<sup>3</sup>
- **RUIA 1997.** "Principal" means property held in trust for distribution to a remainder beneficiary when the trust terminates.<sup>4</sup>

Both definitions refer to the beginning amount of principal (when initially funding a trust). These definitions relate to the accounting procedure of the opening entry, which reflects the beginning principal (equity), which is the offset to recording the trust's assets (net of liabilities, if any) in the appro-

priate detail. This beginning principal amount then changes by later activity, including:<sup>5</sup>

- The resulting gain or loss from the sale or other disposition of property.<sup>6</sup>
- Increases due to liquidating distributions from corporations.<sup>7</sup>
- For trusts, a decrease for half of legal, accounting and trustee fees (the other half being an expense charged against the income account).<sup>8</sup> For estates, such fees generally are charged entirely against principal under RUIA 1962, and for RUIA 1997 the executor is given the discretion to charge these expenses against either income or principal or allocating them in some fashion to each.<sup>9</sup>

These increases and decreases to principal are reflected in the accounting records and attendant financial statements as items of income and expense, and are shown in the income statement of the principal equity account. (It may be helpful to view such a statement as a *principal-income* statement and focus on the fact that the changes being reflected will reduce or increase the prin-

### ILLUSTRATION 2

#### SMITH MARITAL TRUST BALANCE SHEET—INCOME TAX BASIS FOR THE YEAR ENDED DECEMBER 31, 2001

<b>Assets</b>	
First Bank, checking	\$ 107,711
First Bank, money market	180,833
Marketable securities	1,651,627
Note receivable—John Jones	1,750,876
Prepaid federal income tax	<u>21,150</u>
	<u>\$3,712,197</u>
<b>Liabilities And Trust Principal &amp; Income</b>	
Due to Jane Smith	69,327
Trust Principal	<u>3,642,870</u>
Trust Income	<u>0</u>
	<u>\$3,712,197</u>

principal account, finally resulting in its year-end balance.)

In RUPIA 1962, income is defined as “the return in money or property derived from the use of principal, including return received as ... [lists various examples].”<sup>10</sup> And RUPIA 1997 defines income as “means money or property that a fiduciary receives as current return from a principal asset.”<sup>11</sup> For both laws, some of the items includible under this definition are:

- interest income;
- dividends (to the extent not included as principal, as liquidating dividends are);
- the net income from rental of real estate or other property; and
- the other half of legal, accounting and trustee fees (*see* the laundry list of principal items above).<sup>12</sup>

It is helpful to note that these definitions of income are a subset of the usual concept of income from the accounting for commercial enterprises, with the added wrinkle that at the end of an accounting period the net result of such activity is closed to the equity account *income*—as opposed to, for example, retained earnings (for corporations) or capital (for partnerships). Further, the other part of this subset (the usual income/expense items) will be reflected in the principal account of a trust or estate. To which account a particular item belongs—principal or income—depends upon the rules laid out in UPIA.

Another part of the conceptual framework is that a trust or estate will start out with an amount for beginning principal (equity), which will change over the accounting periods by additions (*principal-income* and additional funding activity that may occur) and reductions (*principal-expenses* and distributions of principal). However, the income (equity) account starts with no

beginning balance at inception<sup>13</sup> but will change over future accounting periods by additions (*income-income*) and reductions (*income-expenses* and distributions of income).

## Other RUPIA Derived Accounting Peculiarities

For those familiar with accounting principles and procedures for commercial enterprises, the fact that trusts and estates have two income statements and two equity accounts is a phenomenon that most will be able to understand and put into practice. But there is more. Some additional peculiarities (applicable to both RUPIA 1962 and 1997) are worth becoming familiar with early on; others will be saved until later.

RUPIA has special rules for *depreciation expense*. Depreciation is a reduction of income *and* an increase to principal.<sup>14</sup> This rule may cause consternation for accountants: The accounting entry for a commercial enterprise is to debit *depreciation expense* and credit the balance sheet account *allowance for depreciation*. For a trust or estate, the debit entry would be the same but the credit would be to the principal account, thus increasing this equity account rather than an allowance account in the balance sheet.

RUPIA disallows the amortization of bond premiums or discounts.<sup>15</sup> Thus, reclassification is *not* made between interest income and the carrying value of the bond in the balance sheet as the bondholder receives payments. Due to this omission of the usual amortization entries, the income account will be slighted for a discount situation and the principal account will benefit. The opposite will occur when bonds are acquired at a premium.

## Who Gets What? The Instrument Rules

In a traditional trust where the income beneficiary receives distributions of the income at least annually and the principal beneficiary gets the trust principal upon the death of the income beneficiary, the UPIA rules regarding income/principal determine the benefits to be shared between the beneficiaries. Likewise, with a traditional will, UPIA governs what the income is and who gets it. However, this all can change depending upon the written instrument (the will or trust agreement). Such changes can occur for two reasons: (1) the instrument can override the UPIA rules as to what is indeed income or principal, and (2) the instrument may call for a different arrangement regarding distributions besides the traditional trust or will arrangements. Let us look at how each of these can work to change things for the beneficiaries.

Beginning with UPIA 1931 and continued in RUPIA, these laws provide that the governing instrument’s provisions will trump the UPIA rules as to the determination of income and principal. Specifically, in the process of determining if a certain receipt or disbursement is to be classified as income or principal or allocated between the two, UPIA provides the following ordering rules:

1. Read the written instrument to see if it provides an answer (which is to be followed even if different from UPIA’s guidance).<sup>16</sup>
2. If the instrument provides no answer—follow the guidance of UPIA.<sup>17</sup>
3. Per RUPIA 1962, if neither the instrument nor RUPIA provides an answer, then the item is to be classified based upon what is

“reasonable and equitable.”<sup>18</sup> But RUPIA 1997 provides that such items will, by default, be classified to principal.<sup>19</sup>

A common mistake is making an income/principal determination based upon one’s recollection of UPIA or based upon some previous experience, instead of reading the instrument to see what *really* is the final word. So, for instance, if a trust agreement says that receipts from an IRA or pension account are to be allocated 15 percent to income and 85 percent to principal, you do exactly that, avoiding deciphering the generally more complicated UPIA rules. In short, to the extent the written instrument provides guidance on accounting for income and principal, this guidance is treated by state law as the final authority.

Another word of caution: read *your* state’s version of UPIA. Uniform laws are not guaranteed to be uniform; many states change them to some extent. For instance, RUPIA 1962 requires that depreciation be charged to income and added to principal (as explained above);<sup>20</sup> however, some states have taken a different approach on this. For example, Florida’s statute calls for the charging of an allowance for depreciation *only if* the trust instrument so instructs,<sup>21</sup> whereas Washington law leaves the depreciation decision to the trustee.<sup>22</sup> There are many other examples of states making changes to this uniform law, so reading the state’s law is the only way to discover what the applicable rules are.

If you have read the provisions of the instrument addressing principal and income and you understand state law, other issues still need to be addressed before

you will be able to answer the “who gets what” question competently. These other issues are the distribution provisions of the instrument. Not all trusts follow the traditional distribution model of the income beneficiary receiving the income annually with the remainderman receiving the principal at the end of the trust term. The possibilities for such provisions

are limited only by the boundaries of imagination or for the less inspired, by their forms book. To give some idea of how a departure from the traditional distribution scheme can change things, two common alternatives and how they would alter beneficiary rights and be accounted for are offered for illustration.

**The trust gives the trustee the discretion to distribute all, a portion or none of the trust income, based upon the trustee’s judgment regarding the financial needs of the income beneficiary (and the principal beneficiary receives his interest when the trust terminates).** Should the trustee (appropriately<sup>23</sup>) decide to distribute less than all the year’s income, such distribution would be shown in the charge and discharge statement, leaving a balance in the income (equity) account at year-end. This result does, however, leave an unanswered question: Does this year-end balance in the income account carry forward to future years or should it instead be transferred to the principal account? (RUPIA does not provide

a certain answer to this question.) One should peruse the instrument for guidance, hoping it would provide that either: (1)

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*A COMMON MISTAKE IS MAKING AN INCOME/PRINCIPAL DETERMINATION BASED UPON ONE’S RECOLLECTION OF UPIA OR BASED UPON SOME PREVIOUS EXPERIENCE, INSTEAD OF READING THE INSTRUMENT TO SEE WHAT REALLY IS THE FINAL WORD.*

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the year-end balance in the income account is to remain in this account and be available for distribution to the income beneficiary in future years (if need be), or (2) this income account balance instead will be transferred to principal at year-end (and therefore unavailable to the income beneficiary in the future).

**The income beneficiary is given the option—on a year-to-year basis, should he or she so elect—to receive a withdrawal of principal equal to five percent of the trust principal at the beginning of each year (the so-called five-and-five power). This discretionary principal distribution is in addition to the trust being required to distribute the income annually to the same beneficiary.** Such terms were incorporated into the example shown in Illustration 1, and the corresponding accounting presentation will be found there.

In summary, besides being familiar with your state’s version of UPIA, one needs to interpret the instrument and understand the distribution scheme, before implementing the income and principal determinations of an estate or trust.

## For the Accountants

Though UPIA sets out rules for the determination of principal versus income, it does not address the multitude of relevant accounting principles and conventions accountants need to know when preparing an accounting for a trust or an estate. If the answers provided by an accounting are incomplete or inaccurate, or if they simply lack credibility, beneficiaries will be slighted. For this reason, those doing the accounting need to be competent and knowledgeable in this specialized area. This does not seem to be the case much of the time: Many of the accountings for estates and trusts to which we get access are based solely upon collections of spreadsheets and IRS (form) 1099s. These same accountants would not likely consider doing similar work for a business without relying upon a double-entry system and its checks and balances and other obvious benefits. And those who attempt a real accounting often neglect to become familiar with UPIA. This is a problem attorneys could help solve by giving support to accountants interpreting UPIA, as well as by drafting into wills and trust agreements the requirement for annual financial statements.

But in the end, it is the accountants who will be responsible for *doing* the accounting for estates and trusts. For them, the following references to resources along with some comments should provide useful information. Also, since the revised versions of UPIA (RUIA 1962 and 1997) are the law in the majority of states, the following discussion will deal exclusively with RUIA.

RUIA implicitly addresses the notion of two equity accounts for estates and trusts and explicitly contains the rules for determining how receipts and disbursements will be classified, as between principal and income. With some limited exceptions, RUIA does not address other accounting issues for estates and trusts. These “other” issues include guidance on financial statement presentation and direction on disclosure and measurement principles. We need to look elsewhere to resolve these issues. Before moving on to other sources, here are the few such issues for which RUIA *does* provide an answer.

**Basis of Accounting.** Implicit in RUIA is the cash basis of accounting. The discussion throughout RUIA refers to “receipts,” and “expenditures” or “disbursements,” and those familiar with RUIA interpret such language as a directive to apply the cash basis of accounting.

**Specific Departures from Standard GAAP.** For a handful of specific situations, RUIA provides for an accounting treatment that departs from standard generally accepted accounting principles (GAAP). Two of these situations are discussed under the heading *Other RUIA Derived Accounting Peculiarities* and just need to be committed to memory. The few others that apply will be discussed in future articles.

Some states have other laws that may address financial statement presentation and other accounting principles issues for trusts and estates. Check your state laws to see if this is so. (For instance, Washington has a Trustees’ Accounting Act.<sup>24</sup>) And when presenting a statement or other financial information to

a court, it is the court’s format that must be complied with, regardless of anyone else’s notion of what is appropriate.

There are no Financial Accounting Standards Board (FASB) Statements, Accounting Principles Board (APB) Opinions or the like that deal with trust and estate specific accounting principles. What exists is on the lowest rung of the GAAP hierarchy.<sup>25</sup> Within this category, the (rather limited) resources are (1) the Fiduciary Accounting Principles and the Model Trustee’s Account as presented by the National Fiduciary Accounting Standards Committee, and (2) courses sponsored by the American Institute of Certified Public Accountants (AICPA) on the subject of fiduciary accounting.

The National Fiduciary Accounting Committee produced a document (finalized in 1984) presenting what the Committee considered to be the basic objectives and general standards of fiduciary accounting as well as two sample financial statements—one for an estate the other for a trust. The Committee included members from the American Bar Association, the American Bankers Association, the American College of Trust and Estate Counsel (attorneys) and other professional groups.<sup>26</sup>

The objectives and general standards portion of the Committee’s report contain a number of general statements not relevant to or amendments of standard GAAP (*e.g.*, “A fiduciary account[ing] shall contain sufficient information to put the interested parties on notice as to all significant transactions ...”<sup>27</sup>). However, this portion of the Committee’s report *does* include some statements that are depar-

tures from or embellishments to standard GAAP. These are:

- The financial information presented should include both carrying values (later defined similarly to the cost basis information as would be presented for a commercial enterprise) *and* current values (not later defined, *per se*, but based upon the sample financial statements presented, presumed to be the fair market value). In the financial presentations that followed, this dual-valuation scheme was accommodated by a two-columnar approach with the column headings of *Fiduciary Acquisition Value* and *Current Value*.
- “Gains and losses incurred during the accounting period shall be shown separately in the same schedule.”<sup>28</sup> Accordingly, this rule requires the gains and losses from the sale (or other disposition) of assets to be shown in detail, as opposed to netting the results of individual transactions.<sup>29</sup>  
The Committee’s sample financial statements illustrate some unusual presentation standards. What follows are some of the more unique financial statement presentation conventions reflected in the Committee’s sample financial statement for trusts (*Model Trustee’s Account*).
- Both income statements (that for principal and for income) reflect the *cumulative* activity from inception to the current accounting period.
- The trust’s receipts and disbursements are shown in transaction detail (date, vendor and amount). Also, totals from the date of the trust’s inception to the current year are presented, but yearly totals are not.

- The balance sheet information shows (in two separate columns) both the *current value* as well as the *fiduciary acquisition value* of the assets held.
- There are two balance sheets—one for principal (Principal Balance on Hand) the other for income (Balance of Income on Hand). This splitting of the assets into two balance sheets presents some problems (both theoretical and practical): For instance, if one was interested in the total cash available to the trust, they would have to look at both statements and add the reported cash in each to arrive at this basic information.

The result of these conventions is a tedious, 14-page financial statement for a relatively uncomplicated trust (comprised mostly of securities and originally funded with assets of \$158,000). To say a reader would be buried in sometimes trivial detail *and* have difficulty finding key information is a polite understatement. (As will be discussed later, we have not incorporated these conventions in our trust financial statements, with the exception of item 3, above, *if* the trustee elects to show the current value of trust property.)

An alternative to the above National Fiduciary Accounting Committee’s approach is provided by the Charge and Discharge Statement (CDS) format,<sup>30</sup> a somewhat revised sample of which is included in Illustrations 1 and 2. This CDS statement is also generally presented and discussed in courses on fiduciary accounting.

A detailed discussion of the CDS format and how it varies from that of the National Fiduciary Accounting Committee is beyond the scope of this article. Nonethe-

less, reviewing Illustrations 1 and 2 will allow accountants some insight into the presentation differences, as well as the accounting procedure differences underlying the CDS approach.<sup>31</sup>

The AICPA courses on fiduciary accounting usually include a discussion of the accounting system that bank and trust companies use for fiduciary accounting. This system works reasonably well when a trust is invested in securities (being able to record the gains/losses on sales of securities and interest and dividend income activity without difficulty) but it has some shortcomings handling other financial activity. Although these courses acknowledge that this system is not GAAP, some of the deficiencies of this accounting system have found their way into the accounting standards and procedures for both the National Fiduciary Accounting Committee and CDS models. Some of these deficiencies and the fixes we have devised to correct them are:

- Liabilities assumed by a trust or estate upon funding (such as mortgages on real estate) are omitted from the balance sheet.<sup>32</sup> (Though later acquired liabilities, such as mortgages assumed as part of the purchase of property, are included.) *We do record* the liabilities assumed when a trust or estate is created. Hopefully, no accountant *really* believes omitting liabilities from the balance sheet improves the accounting for an estate or trust, and accordingly will accept our recommendation on this.
- The cash account(s) is bifurcated in the accounting records into two accounts, *cash-principal* and *cash-income*. (The net of the two amounts is the actual cash account bal-

ance.) In the bank and trust company system, this provides a way to keep track of the amount that should be distributed to the income beneficiary at any point in time (as the net activity results in a *cash-income* balance which is equal to the trust’s income less year-to-date distributions to the beneficiary).<sup>33</sup> This procedure, when coupled with the presentation of two balance sheets, can result in such nonsense as an apparent cash overdraft in the *cash-principal* account when no overdraft in total cash exists. Contrary to the approach taught in fiduciary accounting courses, we do not create these two cash accounts but follow the usual standard of a single account for any bank account. Further, we present only one balance sheet, believing the reader will recognize that the amount of each of the two equity accounts represents that equity interest’s claim on the assets. (This approach also has the obvious benefit that all assets and liabilities will be shown in total on one statement.) And to accommodate the need to keep track of the income beneficiary’s due at

any point in time (presuming a traditional trust where the income beneficiary is to receive all income), we make the entries as illustrated in Chart 1.

Accountants working in this area should appreciate that this is a different environment than that for commercial enterprises: In the commercial environment, GAAP and auditing standards are designed around the public policy issue of protecting investors, creditors and lenders. In the trust and estate area, the beneficiaries are the people we need to be concerned about. Considering this, our approach has been to encourage the trustee to offer beneficiaries a choice as to which financial statement format would be most useful and meaningful to them. Most have chosen the CDS model, though some have requested additional supplementary information to suit their needs.

### RUPIA 1997—How Is It Different from the 1962 Law?

Things can change a lot in 30 years. The financial market during the 1960s was quite different from that of the 1990s. During

the 1960s, corporations typically paid out a significant part of their earnings in dividends, interest rates were relatively stable and the stock market appreciated over time at a steady (though not dramatic) rate. This financial environment promoted a basic strategy for many trustees: A mix of stocks and bonds was chosen to allow the income beneficiary his due while still allowing the principal beneficiary growth opportunities over time. The exact mix of stocks/bonds was debated, but the wisdom of such a mix was not in doubt. During the 1990s, all of this changed.

This change in the financial markets gave rise to the changing of uniform laws regarding a fiduciary’s investment practices. These laws focused upon a new performance standard based upon the measurement statistic of *total return*—how the portfolio as a whole performed, regardless of the source (e.g., dividends versus appreciation in value). This new measurement criterion induced many to weight a portfolio significantly with stocks, which might pay little or no dividends (but tended to appreciate over time) and less toward interest earning securities. Based upon the design of RUPIA 1962 and its definition of income this portfolio mix left income beneficiaries with much less.

RUPIA 1997 provides a unique response to this dilemma by giving the trustee the power to adjust between principal and income.<sup>34</sup> (Though the impetus for this law change was based on the notion that a fiduciary would allocate from principal to income, the language of this law would also allow a transfer in the opposite direction.) This power is conditioned upon the trustee applying it in a manner that

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CHART 1

Account	DR	CR
Distributions—Income	100,000	
Due to Income Beneficiary		100,000
<b>To record ytd net income distribution due<sup>1</sup></b>		
Due to Income Beneficiary	90,000	
Cash		90,000
<b>To record ytd actual distributions</b>		
<b>Note.</b> At this point the income beneficiary is due \$10,000 in additional distributions.		

<sup>1</sup> To accommodate the ability to correctly compute the amount of this entry, it would be necessary for the trust’s chart of accounts to distinguish between income and principal (for the two groups of income statement accounts). For instance, the 4000 (income) and 5000 (expense) series would be for income accounts, and those from 6000 (income) to 7000 (expense) would be for principal accounts. This distinction in the accounts should be made in any case, and such is recommended in fiduciary accounting courses.

sales tax on the buyer in *Jefferson Lines, Inc.*, [514 U.S. 175 (1995)] which says you do not have to apportion the tax.

**DRURY:** *Milwaukee Safeguard Insurance* also holds that the burden of proof here is on the taxpayer once the state raises the pass-on defense. Facing that requirement, taxpayers are going to be forced to prove that the economic burden of the tax really fell on them and was not passed through to the customer. Meeting this burden would be difficult, time consuming, and expensive, and it may allow the state to retain unconstitutionally collected taxes to which it is clearly not entitled.

**POMP:** It sounds like another role for economists.

**WETHEKAM:** I think we have given them a whole new life in Illinois. I think this case has serious implications here because the Department, I do believe, would raise it in a corporate income tax case.

**DUNCAN:** First of all, let us be assured it is two different departments that are administering the corporate income tax and the insurance tax.

**WETHEKAM:** It is, Harley, but with all due respect to the Department, if it works here, it will work in other states.

**KRANZ:** You have an Illinois appellate court decision that says it works.

**POMP:** But I assume this is on appeal, right Marilyn?

**WETHEKAM:** A petition for leave to appeal has been filed and COST [Council on State Taxation] has filed a very good amicus brief and

I do not think the petition has been acted upon as of yet.

**KRANZ:** It has not.

## UPIA

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is “fair and reasonable to all of the beneficiaries,”<sup>35</sup> thus safeguarding all involved. Accordingly, a trustee will be able to invest using optimal strategies for the trust as a whole and still maintain a balance between the different interests of the beneficiaries. However, this approach creates its own dilemma: What is the “fair and reasonable” amount of income? Those involved with estate and trust administration will have to wait to see how the answer to this question plays out.

Other less dramatic new rules were added to RUIA 1997, most in response to issues not contemplated in RUIA 1962. In this category are rules for the income/principal determinations of receipts from recently developed financial instruments, including derivatives, various types of options and asset-backed securities.<sup>36</sup> Also new are rules dealing with disbursements made because of environmental laws.<sup>37</sup>

Further, a number of matters provided for in RUIA 1962 have been changed or clarified in RUIA 1997. For instance, income from a partnership is based on distributions from the partnership, as opposed to the trust-partner’s share of partnership income (the RUIA 1962 rule).<sup>38</sup> Another change is that charging depreciation against income is no longer mandatory but is left to the discretion of the trustee.<sup>39</sup> Similarly, the methodology for distinguishing income from principal has changed for receipts from certain kinds of property (e.g., IRA and pension accounts).<sup>40</sup>

## Conclusion

UPIA is not the bible for all beneficiary rights and accounting issues, but at the same time, it is more than a collection of disparate rules on principal and income. What UPIA does offer are the concepts of principal and income as supported by definitions and specific rules for determining how certain receipts or disbursements are to be so classified. UPIA also offers maximum flexibility to trustors and testators by allowing them to override UPIA with their own income/principal classification rules. The possibility that such changes to state law will exist in the written instrument make it necessary for one to interpret the instrument before implementing UPIA. Furthermore, once income and principal are determined, the instrument (not the UPIA!) is the sole source for determining what is to be *distributed* to beneficiaries, making this the final step in answering the “who gets what” question.

The accounting profession has not devoted much attention to developing GAAP for trusts and estates. The GAAP that exists was developed for the most part by professional organizations of the banking and legal profession. Not surprisingly, these efforts contain terminology as well as theoretical and practical recommendations that are inconsistent with those used by practicing accountants, which may in part explain accountants’ lack of attention to this area. Nonetheless, I believe accountants can provide valuable services in this area by extracting the beneficial recommendations from the available GAAP while also being willing to devise fixes for the theoretical and practical shortcomings. Our solution has been to adopt the CDS model with revisions, two of the significant ones being explained in

this article (under the heading *For the Accountants*).

Significant changes in the financial markets occurred during the 1990s. Overall, the resulting investment management obligations pushed a fiduciary toward investments yielding little income as defined by UPIA (or RUPIA 1962), and this thwarted the fiduciary's ability to satisfy his obligation of fair and equitable treatment to *both* the income and principal beneficiary. This conflict may be resolved by RUPIA 1997's provision allowing a fiduciary the discretion to allocate between income and principal. Time will tell how effective this strategy will be in curing the obvious problem. It is worth mentioning that many states that have adopted RUPIA 1997 have also added a "unitrust" provision.<sup>41</sup> The unitrust model is based upon the requirement that an income beneficiary will receive a specified amount of income each year (*e.g.*, four percent of the beginning-of-the-year value of the investments held by a trust) regardless of the income that is computed based upon the standard UPIA income/principal rules.

RUPIA 1997 features other changes. Among them are new sections dealing with the income/principal dichotomy for investment vehicles that did not exist (or were uncommon) when the 1962 law was drafted.<sup>42</sup> And, as to be expected, issues not addressed or which seemed to lack clarity in the 1962 law were dealt with in the 1997 revision.

#### ENDNOTES

- <sup>1</sup> RUPIA 1962 replaced the original 1931 UPIA.
- <sup>2</sup> There is some (limited) subject matter in addition to this principal/income distinction that is addressed in UPIA. This will be discussed later in the article.

<sup>3</sup> RUPIA §3(b) (1962).

<sup>4</sup> RUPIA §102(10) (1997).

<sup>5</sup> The following list is not intended to be all-inclusive. However, the list does include items that are common to both RUPIA 1962 and RUPIA 1997. Differences between these two laws will be left to a later discussion.

<sup>6</sup> RUPIA §3(b)(1) and (8) (1962), and RUPIA §404(2) (1997).

<sup>7</sup> RUPIA §3(b)(4) (1962), and RUPIA §§401(c)(3) and 404(2) (1997).

<sup>8</sup> RUPIA §13(c)(1) (1962), and RUPIA §502(a)(1) (1997).

<sup>9</sup> RUPIA §5(a) (1962), and RUPIA §201(2)(B) (1997).

<sup>10</sup> RUPIA §3(a) (1962).

<sup>11</sup> RUPIA §102(4) (1997).

<sup>12</sup> RUPIA §13(a)(3) and (5) (1962), and RUPIA §501(1) and (2) (1997).

<sup>13</sup> There is an exception to this: Where income earned during the administration of an estate is classified as income for the trust funded from the estate's property.

<sup>14</sup> RUPIA §§13(a)(2) and 3(b)(10) (1962), and RUPIA §503 (1997).

<sup>15</sup> RUPIA §7 (1962) and RUPIA §406 (1997). There are some exceptions to this general rule. One such exception applies to zero coupon bonds and the like, where no income is paid to the holder until the bond matures.

<sup>16</sup> RUPIA §2(a) (1962), and RUPIA §103(a) (1997), *et. seq.*

<sup>17</sup> *Id.*

<sup>18</sup> RUPIA §2(a)(3) (1962).

<sup>19</sup> RUPIA §103(a)(4) (1997).

<sup>20</sup> *Supra* note 14.

<sup>21</sup> Fla. Stat. ch. 738.13 and ch. 738.03.

<sup>22</sup> Wash. Rev. Code §11.104.130(1)(b).

<sup>23</sup> Often such a design includes guidance in the instrument to the trustee as to what factors he/she should consider in making the decision as to the amount of income they will distribute. For the sake of this example, we will presume the trustee responds intelligently and fairly in making this decision.

<sup>24</sup> Unfortunately, this law does not add much to the knowledge base of accounting principles. This rather brief law instructs the trustee to deliver a "written itemized statement of all current receipts and disbursements made by the trustee of the funds of the trust both principal and income ..." Washington attorneys have interpreted this law to mean they are to send a copy of a trust's check register to the court (in the standard format with additional columns for principal and income or simply the description "income" or "principal" alongside each item). When applicable, statements from securities companies are also sent. Since the courts have found this acceptable in most cases, one can

surmise that this low level of accounting satisfies the law. Accordingly, it appears little in the way of accounting principles emanates from this law.

<sup>25</sup> This GAAP hierarchy is as described in FASB No. 111. In this FASB, GAAP is ranked by degree of authority, starting with FASB Statements and ending with "widely recognized and prevalent industry practices."

<sup>26</sup> One member was sent by the AICPA.

<sup>27</sup> *Report of Fiduciary Accounting Standards Committee*, May 1984, at §III.

<sup>28</sup> *Supra* note 27.

<sup>29</sup> The comments following this rule were confined to the "sale or other disposition of securities," though it would be reasonable to extend this to other assets.

<sup>30</sup> This is a long-standing probate court standard format, most popular in the Northeast. It can be viewed as a precursor to the one-page Summary of Account statement which is contained in the Committee's voluminous Model Account[ing]s. In any case, the CDS format along with the revisions we have made to it (to be discussed) is much more concise and more closely aligned with the more familiar financial statement presentations of commercial enterprises than the Committee's format.

<sup>31</sup> For instance, income and expense accounts are closed annually into the equity accounts when following the CDS format (as opposed to maintaining cumulative balances in the income/expense accounts from inception).

<sup>32</sup> Following this treatment, principal is reduced as mortgage payments or payments of other liabilities are made. This awkward approach was developed for the bank and trust company system to work around the shortcoming resulting from not recording assumed liabilities. See *also* note 14, *supra*.

<sup>33</sup> The mechanics of this system are based upon the rule that every cash receipt and disbursement is to be classified as either cash-income or cash-principal.

<sup>34</sup> RUPIA §104 (1997).

<sup>35</sup> RUPIA §103(b) (1997).

<sup>36</sup> RUPIA §§414 and 415 (1997).

<sup>37</sup> RUPIA §502(a)(7) (1997).

<sup>38</sup> RUPIA §401 (1997), versus RUPIA §8 (1962).

<sup>39</sup> RUPIA §§503 and 103(b) (1997).

<sup>40</sup> RUPIA §409 (1997).

<sup>41</sup> Recently, the National Conference of Commissioners on Uniform State Laws added a new §106 to RUPIA (1997), incorporating a unitrust provision within this law. Accordingly, future legislatures adopting this law may use the Commissioner's language should they choose (as opposed to drafting their own unitrust provision to include in their state's law).

<sup>42</sup> For examples, see note 36.