100 INTRODUCTION

100.1 Inevitably, all property accumulated during one's lifetime must be transferred either during life or at death. Estates and trusts are two of the vehicles by which people can transfer their wealth. While hundreds of books have been written about estates and trusts (which are also referred to as fiduciary entities), little has been written on the topic of accounting for and reporting on estates and trusts. This *Guide* provides comprehensive and practical guidance, including analysis of existing authoritative guidance, on accounting and reporting for estates and trusts.

The Need for Guidance

100.2 Over a person's lifetime a significant amount of wealth can be accumulated. In fact, Cornell University professors Robert Avery and Michael Rendall collected and analyzed demographic and economic data leading them to a significant conclusion:

> More than $12 *trillion* are in the hands of America's mature population—the parents of the baby boomers born between 1946 and 1964. [1]

100.3 As the intergenerational transfer of this wealth occurs, it will represent the largest transfer of wealth in the history of the country. After adjustments for inflation and population growth, it may be the largest transfer ever. Several reasons exist for the high dollar amount:

- This mature population of Americans started careers or founded companies following nearly two decades of business stagnation, caused by depression, drought, and war.

- Their frugality was encouraged by the depression experience of the 1930s.

- They are living longer than earlier generations.

- They are among the first to enjoy the benefits of social security based on an entire career.

- During their working years pension plans improved and increased in popularity.

- There has been an unprecedented increase in the value of the stock market during their working careers.

100.4 In past generations parents became financial burdens to their children. Today, many parents have continued to add to their net worth instead of spending down their assets. Rather than becoming burdens, baby boomers' parents will bestow a windfall on their children. It is estimated that most people begin planning for the distribution of their wealth 15 years before the final distribution occurs. Of the $12 trillion of wealth that is expected to be transferred, the bulk of the distributions will occur between the years 2005 and 2030, with the peak happening between 2015 and 2020.

100.5 As a commonly used adage says, “You can't take it with you.” Whether we like it or not, a decedent (deceased person) cannot own property. As a result, all property accumulated during one's lifetime must be transferred either during life or at death. Since most individuals do not like the thought of their life's work being squandered or going to unintended third parties (e.g., the government, in the form of taxes), methods have been developed to assist people in the timely and orderly transfer of their wealth. Different legal entities have been created for the sole purpose of helping people transfer their wealth. Two of these entities are estates and trusts.

The Opportunity for Practitioners

100.6 With the massive amount of wealth transferring hands over the next few decades, practitioners now have an increasing opportunity to provide services relating to estates and trusts. While some practitioners will actually serve in the role of fiduciary, most will be involved with providing accounting and tax services. In some instances, CPAs may be asked to provide financial or other business advice to clients who are acting as executors or trustees. Among the challenges facing practitioners as they begin to provide *accounting and reporting services* to fiduciary entities are:

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

- Vague descriptions from users (including courts, beneficiaries and other interested parties) of the desired presentation format for the requested information and the level of assurance needed.

- Little authoritative guidance exists relating to accounting and reporting for estates and trusts.

100.7 This *Guide* answers the following questions:

- What is an estate and how is it created and terminated?
- What is a trust and how is it created and terminated?
- What property can be transferred to an estate or trust?
- How does an estate or trust operate?
- What is the Uniform Principal and Income Act and what is its relevance to the will, trust agreement, and fiduciary accounting?
- How do fiduciary accounting concepts relate to tax accounting concepts?
- What are the differences between the 1962 and 1997 Uniform Principal and Income Acts?
- How are receipts and charges classified as principal and income?
- How do the Prudent Man Rule and the Uniform Prudent Investor Act affect estates and trusts?
- How does one account for the activity occurring in an estate or trust?
- What bases of accounting may be used?
- What is included in a court accounting?

- How should financial information be presented and what disclosures are necessary?

- Is a report required?

- What are the reporting options?

- What are the issues relating to accountants serving as fiduciaries?

- What effect does the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 have on accounting and reporting for estates and trusts?

Who Is This *Guide* for?

100.8 This *Guide* is designed for practitioners and other individuals who provide accounting or other services to estates or trusts. This includes practitioners who work for accounting firms, trust departments, financial institutions, law offices, or financial planning firms. This *Guide* provides comprehensive and practical guidance, including analysis of existing authoritative guidance on accounting and reporting for estates and trusts. In addition, Chapter 6 discusses issues facing accountants serving in a fiduciary capacity.

100.9 **Topics Not Covered** Trusts are used for many purposes. While their primary purpose is to assist in the proper distribution of property, a discussion of how specific types of trusts operate and how they are taxed is beyond the scope of this *Guide*. Trusts used in pension, profit sharing, and individual retirement account plans are not addressed in this *Guide*. In addition, constructive trusts (which the courts impose in certain situations), charitable, and tax-exempt trusts are not addressed. In addition, bankruptcy estates are not covered in the *Guide*. Finally, a specific discussion of estate planning issues and tax implications of estates and trusts is beyond the scope of this *Guide*. Other PPC resources relating to estates and trusts are discussed in paragraph 100.10.

Other PPC Resources Addressing Estates and Trusts

100.10 PPC maintains an extensive library of products relating to estates and trusts. Other PPC products addressing estates and trusts include the following:

- *PPC's 706/709 Deskbook*.

- *PPC's 1041 Deskbook*.

- *PPC's Guide to Practical Estate Planning*.

- Biebl Ranweiler Portfolio Series *PPC's Guide to Uses and Taxation of Trusts*.

- *PPC's Estate and Trust Consultant*.

- *PPC's Estate and Gift Tax Calculator*.

- *PPC's Estate and Trust Reporter*.

For additional information about these products, call the Thomson Reuters sales department at (800) 431-9025.

Tax Legislation

100.11 Many changes have occurred to the transfer tax system since 2001. The American Taxpayer Relief Act of 2012 (ATRA) established some permanence to the system. With the passage of ATRA, most of the estate, gift, and generation-skipping transfer (GST) tax provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Relief Act) were made permanent. Currently, each individual has an exemption equivalent equal to $5 million indexed for inflation. For 2015, the exemption equivalent is $5,430,000. The opportunity to transfer a decedent's unused exemption amount to his or her surviving spouse (referred to as “portability") was also made permanent. After 2012, the maximum unified estate, gift, and GST tax rate is 40%.

100.12 Given the large exemption equivalent, some people have questioned whether trusts will continue to be useful and necessary in estate planning. The authors believe that trusts will continue to be useful and necessary for a number of reasons, including:

- Some estates still have transfer tax issues. While a large majority of individuals no longer have an estate tax problem, some individuals will still need to use trusts as a mechanism to reduce their estate tax liability while achieving their other estate planning goals.

• Trusts will continue to be necessary to facilitate estate planning, even if a person does not have an estate tax liability.

• Trusts are not created solely for tax reasons. They serve a number of purposes and provide varying benefits, for all sizes of estates, depending on the type and structure of the particular type of trust. For example, trusts will continue to be useful when beneficiaries are minors, immature, disabled, or otherwise lacking in capacity to manage their inheritances. In addition, trusts can be structured to address multiple marriages and children from such marriages, adopted children, spousal equivalents, and the inclusion of charities as beneficiaries.

100.13 While tax laws will have a significant effect on estate planning and taxation of estates and trusts, tax laws have limited effect on accounting and reporting for estates and trusts. Fiduciary accounting principles are not affected by tax law changes. Tax law changes relating to the tax basis of assets received from a decedent generally only affect entities that account and report under the tax basis of accounting. Aspects of estate and trust accounting and reporting affected by tax legislation are discussed in this *Guide*. Practitioners also should consult more detailed information on tax legislation, transfer taxes, and estate planning available in the products discussed at paragraph 100.10.

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[1] SOURCE: *Institutional Investor*, June 1994.

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101 Key Elements of Estates and Trusts

101.1 Every estate or trust involves at least three parties—(a) the creator or grantor, (b) the fiduciary, and (c) the beneficiary(ies). While estates are created when people die and trusts are established for a number of legal and/or tax reasons, estates and trusts are essentially comprised of the following key elements:

• *Estates.* A *testator* creates a *will* that transfers the *estate assets* to an *executor*, who will either hold for the benefit of, or transfer assets to *beneficiaries* in accordance with the terms of the will.

• *Trusts.* A *grantor* creates a trust (*trust instrument*) and transfers *trust assets* to a *trustee* to hold for the benefit of the *beneficiaries* in accordance with the purpose or intent of the trust.

101.2 These elements are introduced in the following paragraphs and in sections 102 and 103. In addition, a glossary of terms relating to estates and trusts is provided at the end of this *Guide*.

Creator/Grantor

101.3 The person who transfers assets to a fiduciary is the creator or grantor of the estate or trust. For estates, the individual making the will generally is called the *testator*. Many states use *testator* and *testatrix* to differentiate between male and female transferors. However, in this *Guide*, any title applies to both sexes. After death, this individual is referred to as the *decedent*. For trusts, the creator or grantor is commonly referred to as the *trustor*, *grantor*, *settlor*, or *donor*. The transfer of assets to the fiduciary entity creates a trust or estate. This transfer occurs at death for an estate. However, in the case of trusts, transfers may occur during the lifetime of the grantor (an *inter vivos* transfer) or at death (a *testamentary* transfer). After its creation, the fiduciary entity operates under the terms of the governing document, which is the *will* for estates and the *trust agreement* for trusts (see paragraph 101.22).

Fiduciary

101.4 A *fiduciary* is a person to whom assets or power is given for the benefit of another person, who is called a beneficiary. The fiduciary is given a legal interest in the assets and has the responsibility to manage and control the assets for the benefit of the beneficiaries. The reason an estate or trust is called a *fiduciary entity* is due to the fact that both entities have fiduciaries who are responsible for their proper management.

101.5 The extent of the fiduciary's power is determined by the testator or grantor. Failure of the testator or grantor to define the scope of the fiduciary's power over the assets in the governing document will result in state law defining the fiduciary's power. However, even if a will or trust document is not specific about the fiduciary's authority, the fiduciary has sufficient power to carry out the purposes of the entity, unless specifically prohibited by law or the governing document. State law concerning estates generally is found in the Probate or Estates Code, while state law governing trusts is located in either a Trust Act or in a Property Code.

101.6 It is the fiduciary's responsibility to administer the trust or estate for the sole benefit of the beneficiaries. In all of his actions, the fiduciary cannot undertake an activity that would be adverse to the beneficiaries or create a conflict of interest between the fiduciary and the beneficiaries. The fiduciary is responsible for (a) filing all legal documents, (b) adequately protecting the assets under his control, and (c) collecting all income and paying all debts associated with the assets. Failure to comply with his responsibilities subjects the fiduciary to liability from the beneficiaries. Since the fiduciary is managing the property for another's benefit, the fiduciary is under the highest standard of care and must be careful not to breach his duty to the beneficiaries. Issues relating to accountants serving as fiduciaries are discussed in Chapter 6.

101.7 **Fiduciary for a Trust** The *trustee* is the fiduciary for a trust. Upon creating a trust, the grantor will transfer legal title to the trustee, who holds it in a fiduciary capacity for the benefit of others (beneficiaries) and is responsible for managing the property for their benefit. The selection of a trustee requires careful consideration. Since a trust can exist for an extended period, the trustee should have sufficient experience and financial management skills to manage the trust.

101.8 An individual or legal entity can be appointed trustee. However, the trustee must have the legal capacity to function in the role of a trustee. They must be able to accept title (ownership) of assets transferred to the trust, purchase and sell assets, pay taxes, etc. The selection of an individual, especially a family member, may be less expensive and more expedient than selecting a professional trustee. However, if the individual lacks experience in managing assets, it could result in lost income or other complications that could defeat the intent of the grantor. Selecting a professional trustee is usually more expensive and lacks the personal touch some beneficiaries need. However, a professional fiduciary's training, resources, and asset management experience may be needed to operate the trust properly. In addition, more than one trustee can be appointed to operate the trust. Further, alternate-successor trustees can be named in the event one or more of the original trustees can no longer serve.

101.9 **Fiduciary for an Estate** The fiduciary for an estate has several different titles depending on the nature of the estate. Since all assets must be transferred at death, the type of fiduciary (also called a personal representative) depends on whether the decedent executed a will before he died or died intestate (without a will). The personal representative of a decedent is known as either an executor (executrix) or as an administrator (administratrix).

101.10 **Executor (Executrix)** An executor (male) or executrix (female) is the person named by a testator in a will to carry out his directions and requests and to dispose of his property according to the provisions of the will after his death. The testator has the right not only to say how his property should be distributed, but also to name any person to serve as his personal representative. If the person named is willing to accept this office and is able to meet the qualifications required by state law, he will be known as the executor. The executor may be an individual or a corporation, such as a trust company.

101.11 Many of the concerns in selecting a trustee also apply in selecting an executor. Normally, an estate is not in existence as long as a trust. Finding someone who can protect the value of assets while properly distributing such assets to the estate's creditors and beneficiaries is the main consideration in selecting an appropriate executor.

101.12 The testator of the will should name alternate executors, in the event the original executor is unable to fulfill his responsibilities. Failure to name a successor results in the probate court naming a successor. A testator can name multiple executors and designate the specific responsibilities each executor will perform in the estate's administration. An executor is subject to the terms of the will and the power of the probate court, unless there is an independent administration (see discussion beginning at paragraph 102.11), which reduces the amount of court authority.

101.13 **Administrator (Administratrix)** In the absence of a will, the decedent has died intestate (without a will) and the probate statues of the applicable state will prescribe how assets will be distributed. The court must appoint an administrator (male) or an administratrix (female) when (a) there is not a valid will, (b) an executor is not named in the will, or (c) the executor is not willing or qualified to administer the estate. Under the Uniform Probate Code (UPC), [2] there is a list of qualified persons, in order of preference, who the court can appoint to serve as administrator.

Beneficiary

101.14 The *beneficiary* is the person, or persons, entitled to receive the benefits of the assets in the estate or trust. This right to receive the benefits of assets is referred to as a *beneficial interest in the assets*, as opposed to a legal interest. In the case of estates and trusts, legal ownership, or the right to retain title, is held by the fiduciary. While beneficiaries do not hold title to the assets, they are entitled to any income that results from the assets.

101.15 There are two types of beneficiaries—income beneficiaries and principal beneficiaries.

- *Income Beneficiary* (or current beneficiary)—An individual who receives the income from the trust or estate assets while the trust is in effect or during the estate administration.

• *Principal Beneficiary* (or remainderman, residual beneficiary, corpus beneficiary, remainder beneficiary)—An individual who will eventually receive the estate or trust assets when the (a) estate or trust expires, or (b) the trust is terminated.

101.16 In the case of both estates and trusts, the income and principal beneficiaries may be the same person. For example, a grantor's children may be entitled to the income of a trust until they reach a certain age, after which they receive the trust principal at that date. These types of beneficiaries, and additional terms applied to estates and trusts are discussed in the following paragraphs.

101.17 **Beneficiaries of a Trust** The types of trust beneficiaries depend on the nature of the asset or property interest received. If a beneficiary received a right to receive income during a stated period (referred to as trust or fiduciary accounting income; see paragraph 201.1), he is called an *income beneficiary* or *life income beneficiary*, depending on the exact nature and length of his income interest. A *life beneficiary* is entitled to the income during the entire period of his life. If the income beneficiary changes during the term of the trust, each successive beneficiary may be referred to as the *present income beneficiary*. A beneficiary who eventually will receive the principal of the trust (a future interest) is called a *principal beneficiary*. Remaindermen (principal beneficiaries) can have vested or contingent future interests in the trust property.

101.18 **Beneficiaries of an Estate** Because there are so many different types of assets and property interests, multiple names have emerged to designate beneficiaries of estates based on the specific type of property they received. A decedent who dies with a will (dies *testate*) is considered to have devised real property to *devisees* and bequeathed personal property to *legatees*. Today, these terms are used interchangeably. A great deal of confusion has been generated by specifically designating beneficiaries based on the type of property they received. Therefore, a *bequest* refers to all types of assets or property transferred by an estate and no particular title, other than *beneficiary*, is given to the *transferee* (the person who receives transferred assets). Although rarely used, the terms *devise* and *legacy* still may be used to describe gifts of real and personal property, respectively.

101.19 Certain terms apply to beneficiaries based on the type of administration or their relationship to the testator. The words *heirs* or *heirs-at-law* commonly refer to persons designated by state law to receive the property of a person who dies without a will (dies intestate). Other terms include *issue*, which refers to a person's descendants and *ancestors*, which includes the testator's ascendants. *Collateral beneficiaries* share a common ancestor with the testator, but they are neither an ancestor nor issue of the testator.

101.20 There are specific names given to the different types of distributions from an estate, which have been used to designate beneficiaries. While these titles do not define the type of property to be received or to designate a beneficiary, they help to determine if a specific beneficiary is entitled to receive property from the testator's estate.

• *Per capita* distributions means that all beneficiaries will receive equal portions of the testator's estate.

• *Per stirpes* distributions result in a beneficiary receiving the share of the estate that his immediate ancestor would have received if he had lived.

101.21 All assets must be distributed from an estate. Therefore, the use of per capita or per stirpes distributions will assure that someone, other than the state, receives all of the testator's assets, even if the named beneficiaries in the will have died or are unable to inherit the property.

101.22 **Governing Document** For estates, the governing document is the will (unless the person died intestate). The will directs how the decedent's assets may be disposed of and/or revokes another will. For trusts, the trust instrument is the document governing its terms and should explicitly state the desires of the grantor. The trust instrument should provide the trustee with guidance concerning the management of trust assets as well as the disposition of trust assets. It should also be specific about how money or other property will be paid to beneficiaries. The provisions in the trust instrument will determine what type of trust it is, how it is taxed for income tax purposes, and whether the trust is included in the gross estate. Because the income and remainder beneficiaries are often different persons, it is important for the trust instrument to provide for the allocation of receipts between income and principal. Chapter 2 discusses the allocation of receipts and disbursements between principal and income beneficiaries.

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[2] The Uniform Probate Code is promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL). The NCCUSL is discussed at paragraph 202.4.

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102 Estates

What Is an Estate?

102.1 An *estate* is a legal entity created at an individual's (decedent's) death that consists of assets that will be transferred in accordance with the decedent's will or through the intestacy laws. Intestacy laws govern what happens and who receives assets when someone dies without a valid will. The term *estate* can have different meanings in different contexts. For example, the *gross estate* consists of property that is subject to estate taxes. For this *Guide*, an estate refers to the probate estate that is managed by the executor. Probate and nonprobate assets are discussed at paragraph 102.26. Since the decedent cannot own property, probate is the formal mechanism for transferring legal and beneficial title to people who can lawfully own and benefit from property ownership. During probate, the executor manages the probate estate so the decedent's creditors can be paid and the remaining property can be transferred to the appropriate heirs. Probate is discussed in more detail beginning at paragraph 102.24.

Will Components

102.2 A will is a revocable legal document that is executed by the decedent and details how and to whom the probate estate should be transferred. Once a person dies, the will becomes irrevocable and is admitted to a court for probate. Probate is discussed beginning at paragraph 102.24. A will is a *testamentary instrument* that makes *testamentary transfers*. Testamentary transfers are transfers made at death. There are three principal types of wills:

a. *Attested Written Will*—follows required testamentary formalities concerning witnesses. (See paragraph 102.6.)

b. *Holographic Will*—written totally in the testator's handwriting.

c. *Nuncupative Will*—oral will that can transfer personal property only.

The types of wills are discussed in *PPC's Guide to Practical Estate Planning*. Call (800) 431-9025 for order information.

102.3 Before the will can be followed in transferring a decedent's assets, it must follow certain requirements, which are referred to as testamentary formalities (see paragraph 102.6). State law determines the formalities that must be followed. Failure to follow the legal requirements results in the document having no legal effect and the decedent's property passing through intestacy.

102.4 Four requirements must be met before a will is valid:

a. The will must identify the testator.

b. The will must be written with testamentary intent. See paragraph 102.5.

c. The testator must have testamentary capacity. See paragraph 102.5.

d. The will must be executed with the requisite testamentary formalities. See paragraph 102.6.

102.5 *Testamentary intent* means the testator executed the will with the intent that it dispose of all probate assets at death. Intent is expressed in the will itself. *Testamentary capacity* means the testator was of sufficient age and had adequate mental capabilities to understand what would occur by signing the will. Most states require a person to be 18 years old before a will can be valid. *Sound mind* is used to express the required mental capacity. On the date a will is signed, the testator must be of *sound mind*, which means the testator has sufficient memory to understand the business being transacted, the effect of signing the will, and the general nature and extent of his property. *Sound mind* must exist when the testator signs the will, but does not have to exist before or after the signing.

102.6 *Testamentary formalities* are concerned with the signing of the will. A will must be signed by the testator and two or more witnesses. Some states require three witnesses, so each state's probate laws should be reviewed to determine the exact number of witnesses required for a valid will. The witnesses must be of sufficient age and not a beneficiary under the will. Most states void a bequest to a witness, unless he would have inherited under the intestacy laws. Then, a witness may inherit the lesser of the bequest under the will or the amount allowed under the intestacy laws. The witnesses must sign the will in front of the testator. Holographic wills do not require witnesses, but must be entirely written in the hand of the testator. No typewritten holographic wills are allowed and any portion of a holographic will that is typewritten is ignored and may void the will. Holographic wills are not enforceable in all 50 states.

102.7 A will can be as simple or as complex as the testator desires. If a specific matter is not covered in the will, state law provides the missing clause or action. Generally, wills contain an *exordium clause*, which identifies the testator, determines domicile (see paragraph 102.29), establishes intent, and revokes all prior wills and codicils (a written change or amendment to the will). An introductory paragraph identifies the testator's family and contains a general description of the assets being transferred by the will. A will should contain the names of all executors and any alternates. If a trust is established by the will, all trustees and alternates should be named. A testator may distribute the probate estate in any legal manner desired. Alternate distribution options may be included in the will to cover those situations when a named beneficiary predeceases or dies simultaneously with the testator. Many states provide for a *self-proving affidavit* that allows a will to be admitted to probate without testimony from any witness. A *self-proving affidavit* indicates the will was executed in accordance with the formalities required by state law. The *self-proving affidavit* is not a part of the will, so it must be signed separate from the will.

102.8 **Bequests** Beneficiaries receive three basic types of bequests:

- Specific.
- General.
- Residuary.

102.9 A *specific bequest* is a gift of a particular item of property that can be identified and distinguished from all other property in the testator's estate. A gift of “my $^{1}/_{4}$ carat diamond ring” is a specific bequest, since the ring can be separated from the rest of the estate's property. A *general bequest* is a gift payable out of the estate's general assets, but no particular property must satisfy the gift. A general bequest is made when the decedent wants the beneficiary to enjoy a distinct value of assets, but does not care which assets are used to satisfy the bequest. General bequests can take the form of a stated dollar amount or be based on a formula. Regardless, the decedent wants the beneficiary to receive a certain dollar value of assets. General bequests can only be distributed after the estate's creditors are paid. A gift of $10,000 would be a general bequest, since the executor could transfer a $10,000 certificate of deposit or distribute the proceeds from the sale of a car to satisfy the bequest. A *pecuniary bequest* is another name often used for a general bequest. A *residuary bequest* is a gift of the estate that remains once all the creditors have been paid and all the specific and general bequest beneficiaries have received their property. Normally, the residue is the largest bequest, since most testators do not make many specific or general bequests.

102.10 In reality, estates are statutory trusts. When the decedent dies, all title to his property immediately vests in the beneficiaries or heirs, subject to any debts and management by the fiduciary. Once letters testamentary (see paragraph 102.34) are issued, the executor is entitled to possession of the property for the purpose safeguarding the assets until all debts and expenses are paid. The executor holds the property in trust and disposes of it according to the applicable state laws. Since the grantor (testator) is dead, the court assumes the role of grantor to supervise the proper disposition of the estate property.

102.11 **Dependent versus Independent Administration** An *independent administration* is one in which the executor can act without the supervision of the probate court. Conversely, a *dependent administration* requires the executor to obtain approval from the probate court before taking any action on behalf of the estate.

102.12 An independent administration is generally preferable because of the flexibility available from the lack of court supervision. Of course, as with every other issue involving probate, the availability of independent administration is a function of state law. Most jurisdictions, recognizing the administrative benefit, do have provisions for independent administration. However, independent administration is available only if the will expressly states that the executor is to be independent of the probate court. If the will does not contain the requisite language, or if the person named as executor is unable to serve, then a dependent administration will be necessary. (Note that some states allow the beneficiaries of the will to elect to have an independent administration even if the will does not expressly provide for one.)

Testamentary and Other Estate Documents

102.13 A testamentary document is one that has no legal effect until the death of the decedent. Such documents typically include the will (see paragraph 102.2), any codicil (addition) to the will, a testamentary letter, and a memorandum disposing of personal assets. None of these documents are required by law to be part of the estate administration process; however, that process typically is made smoother by the presence of one or more of these documents. For a list of documents often used in the administration of an estate, see Appendix 1D.

102.14 As discussed beginning at paragraph 102.2, for the estate of an individual who died testate (with a will), the governing document is the will. A will is a revocable legal document that is executed by the decedent and details how and to whom testamentary transfers (i.e., transfers made at death) of the probate estate should be made. Once a person dies, the will becomes irrevocable and a probate court determines its validity.

102.15 A codicil is an addition or change to a particular provision of the will. The testator often uses a codicil to update the will without having to create an entirely new version of it (which is not such a problem with the widespread use of word processing). When the will is submitted to probate court to initiate administration, any codicil(s) must be attached to the will. The codicil must be executed in accordance with the same formalities required by law as are required for a will to be valid.

102.16 A testamentary letter, an estate planning letter, or a letter of instructions, assists estate administration by supplying the executor with as much information as possible regarding the location of important documents (e.g., will, life insurance policies, burial policies), the decedent's assets and liabilities, and professional advisors and other individuals to consult during administration. It also helps the family and/or the executor better understand the testator's personal desires and requests that may seem inappropriate in a will. These may include the discussion of preferences or previously made arrangements for the funeral and disposition of the body, directions for the distribution of personal property, and other matters of a personal nature. A testamentary letter does not have to be presented in any particular format. Testamentary letters are also discussed at paragraph 102.34.

102.17 A memorandum disposing of specific assets is often used when the testator wishes to leave certain personal items to specific individuals. Since updating the will every time there is a change in assets would be burdensome, a memorandum may be used and incorporated into the will by reference. The memorandum is generally kept in the same place as the will.

Other Forms and Documents

102.18 Numerous forms and documents involved in the administration process must be submitted to the court at some point during administration and are required by federal, state, and local jurisdictions. Other items are needed in the collection and distribution of assets.

102.19 The specific forms and documents required by the probate court typically vary according to several factors such as—

- the type of administration selected for the estate,
- the existence of a valid will,
- whether the validity of the will or the appointment of the executor is contested, and
- the state's probate provisions.

102.20 Most of the applications, forms, court orders, letters of authority, etc. that are submitted to or issued by the probate court can be obtained from the court clerk or the estate's attorney, and many also can be downloaded from sites on the Internet. Other items needed during the administration are specific to each estate. They typically include life insurance policies, beneficiary designations under retirement plans, bank accounts, signature cards, employment and organizational benefits, brochures, and brokerage accounts signature cards. During the discovery portion of the administration process, it is important to determine whether each is a probate or nonprobate asset. Many of these items are listed at Appendix 1A.

Lifecycle of an Estate

102.21 The lifecycle of an estate, including how it is created, distinguishing between probate and nonprobate assets, and an overview of the probate process, is discussed in the following paragraphs.

102.22 **Creation of an Estate** An estate is created when a person dies. Upon death, the decedent's assets will be transferred under a will or through intestacy.

102.23 A *will* is a revocable legal document executed by the decedent that details how and to whom the decedent's assets should be transferred. When a decedent fails to execute a will, his property is transferred by intestacy according to the Probate Code. In either case, the resulting entity is called a *probate estate*, since the decedent's property is being transferred according to the probate laws of the applicable state.

102.24 **What Is Probate?** The term probate is derived from a Latin root word that literally means "to prove." In reality, the probate process encompasses more than just proving the validity of a will. It includes the entire administration process of determining the decedent's assets; paying debts, liabilities, and taxes; and distributing the remaining assets to the beneficiaries. In effect, probate is the process that enables the beneficiaries to receive property that is rightfully theirs.

102.25 The probate process involves situations in which a person dies and leaves a valid will (testate), as well as those in which a person dies without a will (intestate). When a will exists, the probate process involves establishing its validity. If no will exists, the process centers on establishing who is entitled to receive the property under state law. In either event, the evidence will be presented to the court having probate jurisdiction and typically requires the services of a qualified attorney. Because of its associated costs, many people try to structure their financial affairs in order to avoid probate.

102.26 **Probate versus Nonprobate Assets** Only property (assets) subject to the Probate Code is included in the probate estate and is considered during the administration of the estate. Other types of property transfers are available by which property passes directly from the decedent to the beneficiary and never becomes part of the probate estate. Only activity within the probate estate is reflected on a federal estate income tax return. In addition, the probate estate does not include all property included within the gross estate for federal estate tax purposes. Many assets may be transferred at death outside probate, but are included in the gross estate. For example, life insurance proceeds pass according to a contractual agreement between the policy owner and the insurance company. Individual retirement accounts are distributed pursuant to a designated beneficiary declaration. Joint tenancy property passes by operation of law to the surviving joint tenants. Assets placed in an *inter vivos* trust are transferred according to the trust terms. While each of the assets might be transferred to someone at the testator's death and included in the gross estate, these assets are not included within the probate estate, since they are transferred based on an alternate distribution plan. The treatment of probate and nonprobate assets for accounting purposes is discussed in section 303. See Appendix 1B for a partial listing of probate and nonprobate assets.

102.27 **Overview of the Probate Process** The probate process is detailed in the Probate Code. It is the legal proceedings required to transfer the decedent's probate estate to the designated beneficiaries while paying off the decedent's creditors.

102.28 The three main purposes for probate are to—

- Protect creditors.

- Implement the wishes of the decedent.

- Convey clear title to property.

102.29 Probate must generally start within four years after the decedent's death although some states may require a shorter period. After that time, anyone purchasing property from the decedent's heirs are considered to have good title. If the decedent had a domicile or fixed place of residence in the state, the process is started by the executor or interested party filing an application or petition (see paragraph 102.31) with the probate court or county court at law located in the county where the decedent resided. *Domicile* is the legal jurisdiction (e.g., state) in which the decedent maintained and intended to maintain a permanent residence. Domicile differs from residence, because a person may be domiciled within a jurisdiction even though he does not reside in that jurisdiction at the present time. A person can have only one domicile, and it is determined by the facts.

102.30 If a person has real property located in a state different from his domicile, there may be a need for an *ancillary administration* of the will in the non-domiciliary state. An ancillary administration is a probate proceeding in a legal jurisdiction (i.e., state) other than the jurisdiction of the decedent's domicile. This proceeding is necessary to clear title to the real property located in a state other than the state in which the decedent was domiciled at the time of death. Each state has its own provisions on how to conduct an ancillary administration.

102.31 **Initiating Probate** As discussed at paragraph 102.29, to commence the probate process, an application or petition must be filed with the applicable probate court or county court of law. The name of this filing differs by jurisdiction, but common titles include “petition for commencement of proceedings” and “petition for probate of will.” The petition or application asks the court to (a) admit the will for probate and appointment of the executor or (b) state that the decedent died intestate and ask the court to appoint an administrator. While the content of the application varies between states, it generally includes the following information:

- A request that the will be admitted to probate.

- The date of the will, names of its witnesses, and the name and address of the executor.

• Information about the deceased, including name, date of death, age, social security number, and domicile.

• The names and addresses of beneficiaries.

• Facts to show that the court can hear the case (jurisdiction and venue).

• The nature of the decedent's property (real and personal) and its probable value.

• Information about whether (a) the decedent was ever divorced, and (b) any children were born/adopted to the decedent after making the will and survived the decedent.

• Statement that the executor is not disqualified from serving.

• Information about whether the state, a governmental agency of the state, or a charitable organization is a beneficiary of the estate.

102.32 Once the application is filed, a hearing is held to determine if the will should be probated. If the court finds that the required testamentary formalities were followed, the court approves the will for probate and appoints the executor.

102.33 **Notice of Appointment** The executor must take an oath of office and unless the will provides otherwise, the executor must post bond. After appointment, the executor must file a notice of his appointment in a newspaper in the county where the probate proceedings are taking place. The purpose of the notice is to notify creditors of the probate proceeding, so they can file claims against the estate for the payment of the decedent's debts. If the executor has actual knowledge of a debt, the executor must send notice to the creditor within four months of appointment (or other period specified by the court).

102.34 **Issuance of Letters Testamentary** Within 20 days of appointment (or other period specified by the court), the court will issue *letters testamentary* to the executor. Letters testamentary are issued by a probate court to give the executor the authority to act on behalf of an estate with respect to a decedent's property. This includes the power to collect the decedent's assets, pay the decedent's debts, and distribute the decedent's property. Once the letters testamentary are issued, the executor can begin administration of the estate. In some states, letters testamentary are referred to as *letters of authority*. See Appendix 1C for an example of a letters testamentary.

102.35 **Estate Administration** During the estate's administration, but within 30 to 90 days after appointment (or other period specified by the court), the executor must file an inventory, appraisement, and list of claims. The inventory, which must be filed with the probate court, should contain a list of the decedent's assets that are subject to probate procedures (probate assets) valued as of the decedent's date of death. The property is usually listed according to separate and community property (if applicable) and real and personal property. The fair market value at the date of death is listed for each piece of property on the inventory. In some jurisdictions, any mortgages or liens outstanding against the assets are also listed. An affidavit is attached to the inventory stating its truth and completeness. Upon submission, the court will either approve or disapprove the inventory, and if disapproved, a new inventory must be filed. After the inventory is approved, if additional property is discovered, a supplemental inventory must be filed. The inventory is used by the executor to prepare any estate tax returns and to determine the extent of the assets available to pay claims and distribute to the beneficiaries.

102.36 Upon the death of a testator, all probate assets immediately become the property of the beneficiaries subject to the probate process. So effectively, an estate is funded at the testator's death. The reason for this rule is to prevent a decedent from owning property. The beneficiaries have no right to the assets until the probate process is concluded or the executor makes a distribution. Probate assets are subject to the management and protection of the executor and must be used to pay all debts and expenses before being transferred to the beneficiaries.

102.37 **Distribution of Assets** An executor should not distribute property to any beneficiary until sufficient debts have been paid to guarantee that enough assets will exist to pay all remaining debts and expenses. This includes payment of all probate administration expenses, taxes, and any claims allowed against the estate. In some states, the executor must file an accounting (see paragraph 102.38) and present a plan for distribution before making distributions. Through the probate process, an executor removes the name of the decedent from all assets and either (a) sells the asset to generate cash for payment of debts and expenses or to facilitate distributions or (b) places the name of the beneficiary on the asset thereby distributing the asset to the beneficiary. Asset sales are limited to those necessary to facilitate the probate process. A beneficiary does not have to consent to any action of an executor.

102.38 **Accounting** In most jurisdictions, an annual *accounting* must be filed by the executor. The accounting generally provides information about the estate's assets and payment of the decedent's debts. Most accountings also detail any new property collected, the receipts and disbursements relating to the estate, and the status of all assets under the executor's control. Once all of the debts have been paid and there is no need for further administration, the executor will prepare a final accounting. No accountings are required under an independent administration unless requested by a beneficiary or the court. Accountings, including various types of accountings and presentation formats, are discussed in detail in Chapter 4. Chapter 3 discusses the accounting principles followed by estates.

102.39 **Termination** Once the final accounting is approved, the executor will be discharged. Estates are not supposed to have a long life; therefore, the court can remove an executor for failing to close an estate after a specified period. This may be as short as two to three years.

Special Rights of Family Members

102.40 Whether the decedent had a will or not, state law provides certain family members with rights to the decedent's assets to avoid unintended financial difficulties. These rights are in addition to any rights granted by the will. Normally, these rights are applicable if the surviving family members' own assets are insufficient to sustain them during the probating of the decedent's estate. Sometimes, these rights can extend beyond the formal probate, granting these family members with rights to assets that would otherwise go to other beneficiaries. Whenever a beneficiary's assets are inadequate for normal living expenses, these laws should be investigated. The following paragraphs briefly discuss these rights.

102.41 **Rights of Surviving Spouse** When a married person dies with a will, the rights of the surviving spouse are usually determined in accordance with the provisions in the will (however, see the discussion later in this section concerning the surviving spouse's elective share). If the married person dies without a will, the surviving spouse's rights are determined in accordance with the applicable state's intestacy statutes.

102.42 Surviving Spouse's Elective (Forced) Share. Most states have a statutory provision allowing a surviving spouse to keep a specified portion of a decedent's estate. This is to protect a spouse from being totally disinherited at the time of the death of the spouse who holds title to all of the property. The surviving spouse can choose to take the benefits provided under the will or can choose to take the statutory elective share of the deceased spouse's estate established under the applicable state statute. In some states, the elective share is the same amount the surviving spouse would receive if the decedent spouse had died without a will. Under common law, the widow was entitled to the use and possession of one-third of the decedent's real property. With the elective share statutes, the surviving spouse is generally granted the election to keep a portion of the decedent's assets. The personal representative should consult with the estate's attorney for assistance to determine the applicable amount.

Example 1-1: Surviving spouse's elective share.

John and Betty were previously married and both had children by a prior marriage. John's will provided for Betty to receive 20% of his estate, and the remaining balance of the estate was to be split equally among his four children. When John died, Betty decided to claim her elective share, which under state law was one-third of all of John's property. The remaining two-thirds of John's estate was divided equally among his children.

102.43 The surviving spouse must make this election in accordance with the terms of the state law. The election is made when the surviving spouse gives written notice to the personal representative of the estate and files the notice with the probate court. The estate's attorney should be consulted for properly drafting and executing the notice of election, in accordance with applicable state statute. If this choice is made to elect “against the will,” the surviving spouse therefore legally waives the will and takes whatever the state statute provides and forfeits any further claims to property under the will.

102.44 Elective share statutes vary from state to state. Because of these varying statutes, a critical issue concerning the elective share is the determination of which state has the appropriate jurisdictional authority to settle the estate. In matters such as these, the question of jurisdiction generally depends on the decedent's domicile. The issue of domicile can be important when the surviving spouse is not named as a beneficiary under the deceased spouse's will or receives less under the will than entitled to under the state's elective share statute. If domicile is a legitimate question, the surviving spouse will usually argue in favor of a domicile in the jurisdiction that provides the spouse the largest share of the decedent's estate.

102.45 Community Property Right. In community property states, there is not as great a need for protecting the interest of the surviving spouse since such a person is the legal owner of half of the community property. However, there are certain areas of protection that are provided to surviving spouses, particularly in marginally solvent estates. It is often necessary to bring the case before the probate court to enforce these rights.

102.46 Homestead Right. One right of a surviving spouse in many states is the homestead right. This is the surviving spouse's (or sometimes minor children's) right to the use and possession of the decedent's principal residence. This right exists regardless to whom the property passes under the will or by means of intestacy. In many states, this right is similar to a life estate. The difference between a homestead right and a life estate is that in some states a homestead right can be abandoned. That is, once a surviving spouse moves away from the residence, all rights to future use and occupancy are forfeited. (See homestead exemption discussed at paragraph 102.57.)

102.47 Effect of Divorce on Spouse's Rights. If the testator (maker of the will) obtains a divorce (termination of the spouse's marital status, not merely legal separation) after executing a will (and does not amend the will), state law determines the effect on the will. Most states provide that a divorce revokes only provisions in the will that benefit the former spouse, not the entire will. Any gift to the former spouse then passes to the residuary beneficiaries of the will (UPC sections 2-802 and 2-804).

102.48 Effect of Marriage on Spouse's Rights. There are some states whereby the testator's subsequent marriage after creating a will causes the entire will to be revoked. However, as previously discussed, the majority of states have the elective share statute. The elective share statute would cover the new spouse in this case, thus overriding any such “will revocation” statute. Several states and the UPC provide the new (omitted) spouse with an amount equal to what the surviving spouse would normally receive under the applicable state's intestacy laws, unless the omission was intentional by the testator or the testator provided for the new spouse outside the will in lieu of a testamentary provision.

102.49 **Rights of Children** A natural child is a child to its parents by birth, as opposed to adoption. Although most testators may leave all or most of their estate to their surviving spouse, state law intestacy statutes differ from those testamentary provisions. When both a spouse and children survive an intestate decedent, both the spouse and the children will receive property under state intestacy statutes. The amount differs among the states. When a single parent or a surviving parent-spouse dies intestate, the natural children are first in line to receive the entire estate.

102.50 Generally, parents are not required to leave anything to their children. Excluding children from the estate can be accomplished by inserting a provision or clause into the will specifically stating that a certain named child is intentionally omitted from sharing in the estate. Absent such specific exclusion stated in the will, in some states the child may ultimately receive a share of the estate under an omitted child statute (see discussion beginning at paragraph 102.54).

102.51 Adopted Children. State statutes vary regarding the inheritance rights of adopted children. The UPC (and states that have adopted the UPC) treats the adopted child as a natural child of the adoptive parents and not as a child of the former natural parents (UPC section 2-114).

Example 1-2: Adopted children.

Fred and Julie adopt Cindy's son, John. John has the right to inherit from either of the adoptive parents, Fred or Julie, when they die intestate. John can no longer inherit from his natural mother, Cindy.

102.52 These adoption rules apply only to an intestate situation. A testator may treat adopted children in any manner desired. The personal representative should closely review the will and consult with the estate's attorney if necessary to determine the intended treatment of adopted children.

102.53 Children of Unwed Parents. A child of parents who are not married to each other is often referred to as a nonmarital child. Nonmarital children's inheritance rights are governed by state statute. Most states provide that nonmarital children have the right to inherit from their mother, but the states vary significantly regarding the children's inheritance rights from their father. Some states in fact control a nonmarital child's inheritance rights from their biological father by requiring either an acknowledgment by the man that he is the biological father of the child or otherwise by convincing evidence that he is the father. Today, DNA identification is the most accurate method used to establish paternal proof.

102.54 Omitted Children. Unlike a spouse, children can be disinherited from their parents if the omission is intentional. Most states have statutes that allow a child who is unintentionally omitted in a will to receive a share of the parent's estate. The UPC and some states that have not adopted the UPC include only omitted children that were born after the will was executed (UPC section 2-302). Other states cover children born before or after the deceased parent's death. For adopted children, the date of adoption rather than the date of birth is controlling. Essentially, a parent can leave a child nothing but must do so expressly and clearly in the will, otherwise the assumption is that the omission was inadvertent and not intended.

102.55 **Certain Other Rights of Family Members** In addition to rights of a surviving spouse or children that are established by will or by state intestacy laws, certain other specific rights are afforded to family members. These rights are established by other specific statutes (both state and federal) and include the homestead exemption, homestead allowance, a family allowance, and certain exempt property. They also take priority not only over the decedent's will or the state's intestacy laws, but also creditor's claims against the decedent's estate. These provisions are designed to protect the family members and to allow for a minimum level of property when the decedent's estate is insolvent.

102.56 All of these rights will vary among the states. The estate's attorney should be consulted to determine the availability of any of these specific rights to the surviving spouses and children in a given situation.

102.57 <u>Homestead Exemption</u>. The homestead exemption exempts a homeowner's homestead from claims by creditors regardless of the amount of the homeowner's debt. (Note that this exemption does not apply to a secured creditor that has a purchase money security interest in the property.) The homestead is defined as the house and adjoining land occupied by the homeowner. The amount of land comprising the homestead varies among the states. There is usually a distinction between a rural homestead and an urban homestead, with the rural homestead comprising several more acres than an urban one.

102.58 It is quite common for spouses to hold title to their home in joint tenancy or tenancy by the entirety. With the right of survivorship, the homestead automatically passes to the surviving spouse by operation of law, in the case of death of a spouse.

102.59 <u>Homestead Allowance</u>. Some states provide a cash award called a homestead allowance in lieu of a homestead exemption for the benefit of a surviving spouse or minor children. This is a substitute for a homestead exemption in those cases in which the decedent did not own a principal residence. This allowance is also exempt from creditor's claims and is a priority payment in addition to any property passing to the surviving spouse or minor children by will, intestacy laws, or by a surviving spouse's right to an elective share (see paragraph 102.42 and UPC section 2-402).

102.60 <u>Family Allowance</u>. It is common for many states to grant authority to the probate court to award the surviving spouse and minor children a monthly cash allowance from the decedent's estate for their support during the period of estate administration. The amount of this family allowance can vary among the states and is usually based upon the assets and liabilities of the estate in consideration of the family's financial needs. The allowance cannot be affected by the decedent's will and is also exempt from the claims of creditors.

102.61 <u>Exempt Property</u>. Many states and the UPC exempt a limited amount of personal property of the decedent from creditor's claims and allocate this to the surviving spouse and/or children. There are various state law limitations and exclusions regarding the types of exempt property available. Under the UPC, the selected exempt property goes to the surviving spouse or to the children equally if there is no surviving spouse.

Example 1-3: Exempt property.

Benjamin died, survived by his wife and two children. At the time of his death, he owned a home with no mortgage, $8,000 of personal property, an automobile, and stock worth $12,000. He also owed $20,000 in credit card debt. Absent the family allowance and set aside of exempt property statutes, the creditors would be entitled to the decedent's interest in the personal property, the automobile, and the stock. If his wife petitions the probate court for a family allowance and a set aside of exempt property, she may receive all of the property free and clear of all debts. The same result could be achieved if there were no credit card debt, but Benjamin's will left all of his property to someone other than his spouse.

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103 Trusts

What Is a Trust?

103.1 A *trust* is any arrangement by which title to property is held by one person or a group of persons with a fiduciary responsibility to conserve and protect the property for the benefit of another person or persons. The trustee holds legal title to property in a fiduciary capacity for the benefit of others, pursuant to a written instrument. Trusts provide a great deal of flexibility in transferring property from one generation to another.

Uses of Trusts

103.2 A trust can be one of the most beneficial ways of transferring and holding assets. There are many reasons, other than income and estate tax savings, for making gifts in trusts instead of outright to a donee. Professional asset management is a leading reason for using a trust instead of making an outright gift. Many grantors do not have the confidence that a child, spouse, or other donee has the skills necessary to invest, manage, or make the appropriate business decisions necessary for outright gifts. This is especially true with minor children or incompetent adults. Sometimes, a particular asset the donor wishes to give to several beneficiaries is not easily divisible, such as a piece of real estate or a family business. Trusts are also used to protect assets from the grantor's or beneficiaries creditors.

Types of Trusts

103.3 There are different types and purposes of trusts. The names assigned typically designate the particular purpose of the trust. While every trust must follow the basic provisions discussed beginning at paragraph 103.12, each has certain characteristics that makes it unique. Although discussion of the individual types of trusts is beyond the scope of this *Guide*, it is important to understand certain attributes of different types of trusts. Generally, a trust is affected by the following factors:

- When the trust is formed.

• The degree of the grantor's control.

Each of these factors, which is discussed below, impacts the ultimate legal form of the trust.

103.4 **When the Trust Is Formed** Trusts can either be created:

• *During the Grantor's Life.* Trusts set up during the grantor's lifetime are called *inter vivos* trusts or *living* trusts. Common types of *inter vivos* trusts are:

•• Revocable living trusts.

•• Insurance trusts.

•• Children's trusts.

•• Charitable remainder trusts.

•• Charitable lead trusts.

• *At the Grantor's Death. Testamentary trusts* become effective only upon the grantor's death. Testamentary trusts are contained in wills. Common testamentary trusts include:

•• Trusts for spouse.

•• Trusts for minor children.

•• Charitable remainder trusts.

•• Charitable lead trusts.

103.5 **Degree of the Grantor's Control** Another way of differentiating between trusts is by considering the degree of control retained by the grantor. Trusts are either revocable or irrevocable, as follows:

- *Revocable trusts* allow the grantor to change or revoke terms of the trust.

- *Irrevocable trusts* are set up so that the grantor does not have the power to change or revoke it.

103.6 Differentiating between types of trusts based on the degree of control retained by the grantor is not absolute. In rare instances, a grantor may be allowed to make changes to an irrevocable trust. For revocable trusts, the degree of control retained varies depending on the objectives of the type of trust. Also, revocable trusts become irrevocable upon the death of the grantor.

103.7 **Legal Types of Trusts** To help practitioners understand the nature of the various types of trusts, Appendix 1D includes a partial listing of types of trusts. The appendix provides an overview of the purpose and income tax treatment of certain trusts. Additional information relating to specific types of trusts can be obtained in the PPC Guides listed at paragraph 100.10.

103.8 **Classification for Tax Purposes** While this *Guide* does not focus on tax issues, practitioners may encounter several terms relating to the classification of trusts for tax purposes. Two types of trusts are named in the Internal Revenue Code (IRC) provisions that determine the taxation of estates and trusts:

- Simple trusts.

- Complex trusts.

103.9 The main reason for these labels is to determine the applicable Code sections that apply to any distributions from these trusts. IRC Sections 651-652 apply to simple trusts and IRC Sections 661-663 apply to complex trusts. Other tax sections control all other tax items (e.g., exemptions, etc.).

103.10 *Simple trusts* must meet all three of the following requirements:

- The trust instrument must require all income to be distributed currently.

- The trust instrument must not allow amounts to be paid, set aside, or used in the tax year for charitable purposes.

- The trust does not make distributions from principal (corpus) during the year.

103.11 Any trust not meeting all three criteria of a simple trust discussed in paragraph 103.10, is a *complex trust*. Unless a trust is required to distribute its income currently, the trust will be taxed like a complex trust, even if all of its income is actually distributed. All trusts will be complex in their final year, since any principal remaining in the trust will be distributed in the trust's final year. Taxation of trusts is discussed in *PPC's 1041 Deskbook*.

Creation of a Trust/Components of Trusts

103.12 As discussed at paragraph 103.1, a trust is any arrangement by which title to property is held by one person or a group of persons (the trustee) with a fiduciary responsibility to conserve and protect the property (also known as trust principal or corpus) for the benefit of another person or persons (beneficiaries). There are six basic required elements when establishing a trust:

- Intention to create a trust.

- Trustee.

- One or more ascertainable beneficiaries.

- Specific property placed in trust.

- Meet written requirements.

- Must terminate or fail, unless to a charity.

Each of these elements is discussed in the following paragraphs.

103.13 **Intention to Create a Trust** The grantor (settlor, trustor, donor) must intend to create a trust, before a trust is created. Intent is a question of fact. Courts will not create a trust unless the grantor has expressed the desire that the transaction be construed as a trust. Intent is often a matter of inference from the powers expressly granted and duties expressly imposed within the trust agreement. Generally, the language of the trust instrument is used to determine if the grantor intended a trust. If the intent of the grantor is not clearly reflected in the wording of the trust instrument, the courts can consider the entire instrument as a whole and the events surrounding its execution to determine if the grantor wanted to create a trust.

103.14 **Trustee** The trustee is responsible for management of financial assets in accordance with the trust instrument. Once a grantor decides to use a trust and selects the property to be transferred, he or she must decide whom to select as trustee. The trustee can be an individual, a corporation with trust powers, or any combination of individuals and/or corporate fiduciaries. The grantor often desires to be trustee to maintain control over the investment decisions and distribution of assets. However, for tax and nontax reasons, a third-party trustee, and in many cases, a corporate trustee, may be preferable.

103.15 As discussed at paragraph 101.8, before someone can be appointed trustee, the person must have the legal ability to take, hold, and transfer the trust property. In addition, if the trustee is a corporation, the corporation must be able to act as a trustee in the applicable state. The grantor or a beneficiary may be named a trustee, provided a single person does not hold all legal and beneficial interests conveyed into the trust. The same person can be grantor, trustee, and beneficiary, provided that part of the legal and beneficial interests are separate.

Example 1-4: Creation of a trust.

Jana, age 65, establishes a trust to provide her income for life and at her death the trust property will be distributed to her son Edwin. Jana is the trustee of the trust. This would be a valid trust, since Edwin, who is a different party from the grantor, the trustee, and the income beneficiary, owns the remainder interest. If Jana had named her estate as the remaindermen, no trust would have formed, since a different party would have owned no interest.

103.16 Not only must the grantor name a trustee, the trustee also must accept the appointment. Signing the trust instrument, executing a separate written agreement, or exercising the powers of a trustee are evidence that the trustee has accepted the position. No one can be forced to serve as a trustee. If the original named trustee will not or cannot serve, the court will appoint a trustee, unless the grantor named an alternate who will accept the position.

103.17 **One or More Ascertainable Beneficiaries** A trust cannot exist unless the legal and beneficial interests have been divided. Therefore, the existence of a beneficiary is required before a valid trust can exist. Generally anyone who can own property can be a beneficiary. Minors can be beneficiaries, although they cannot hold legal title, and distributions from the trust can be made directly to a minor. While minors can own property, they cannot transfer property. If property needs to be managed while a person is a minor, legal title must be held in a trust by a person legally able to buy, sell, or lease property until a minor reaches majority.

103.18 In naming the beneficiary of a trust, the main requirement is to designate them with sufficient clarity and certainty to be capable of identification, although not necessarily by name. If the object of the trust cannot be identified, the trust will not be considered a trust for legal or tax purposes. While the beneficiaries do not have to be alive when the trust is created, they must be able to receive property when the trust is required to make a distribution or when it terminates. Therefore, beneficiaries must "come into existence" at some point before the trust terminates. An example is a trust set up for the grantor's grandchildren—at the date the trust is established, all of the grantor's grandchildren may not have been born.

103.19 Only the grantor can name the beneficiaries. The beneficiaries can either be specifically named individuals or can be a designated class of people.

Example 1-5: Trust class.

Children would be a proper class, since they can be determined with reasonable certainty. However, establishing a trust for the grantor's friends would not be a proper class, since it is impossible to determine exactly who are the grantor's "friends."

If a class has been designated, the trustee can have the power to allocate the economic benefits between the different class members, but the trustee cannot name the particular class or any other beneficiary.

103.20 It is important for the grantor to plan for contingencies. For example, the trust instrument should address the following questions:

- What happens to the trust property if a beneficiary dies before the trust terminates and is transferred to the remaindermen?

- What happens if the remaindermen are deceased at the end of the trust's term?

103.21 Failure to name alternate beneficiaries or enabling the beneficiaries to name subsequent beneficiaries will result in the trustee holding the property for the grantor's estate.

Example 1-6: Trust contingencies.

Pursuant to a divorce, Harry established a trust for the benefit of his son, David, until David reached the age of 30. When David turns 30, the trust would terminate and the remainder would be distributed to him. Assume that David died before reaching 30. Since the trust did not provide for an alternate distribution or allow his son to name who would receive the trust property, the trust estate reverted back to Harry or Harry's estate.

103.22 Whenever a trust is established, the beneficiary is presumed to accept the benefits of the trust. However, the beneficiary is not obligated to become a beneficiary. Before a beneficiary has exercised either dominion or control over the economic benefit of the trust, he can disclaim the beneficial interest by sending a written refusal to the trustee within nine months (or other period specified by the court) of being named as a beneficiary. “Dominion and control” over the transferred property refers to any power over the disposition of the property.

103.23 **Property Placed in Trust** Before a trust actually exists, some property must be transferred to the trust. Therefore, the grantor must divest himself of the property, dividing the legal and beneficial interest in the property. Often a grantor intends to establish a trust, but does not want to relinquish control of the property. However, until the property is transferred to the trust (i.e., owned by the trust), the trust does not exist. A grantor can establish an unfunded trust during his life to collect life insurance proceeds and other bequests at his death. Unless prohibited by the trust instrument, the grantor can add property to the trust at any time during its existence. The property placed in trust is called the *corpus* or *principal*.

103.24 **Written Requirements** A trust is valid only if there is written evidence of the trust's terms signed by the grantor. This applies regardless of the type of property placed into the trust. If personal property is placed into the trust, the trust will be enforceable if—

- the grantor expresses an intent to create a trust, and the trustee is not the grantor or a beneficiary, or

- the grantor declares in writing that he holds the property as a trustee for himself and another.

103.25 A trust cannot be established for an illegal purpose. Further the grantor can reserve certain interest and powers over the trust. The purpose and reservations must be spelled out in the trust document. By requiring a written document, state law forces the grantor to determine the exact nature of the trust. The trust document controls the entire operations of the trust. The grantor has total control on how the trust is to operate. The grantor's instructions relating to how to account for a certain transaction is dictated by provisions included in the governing document. Due to the power granted to the grantor, a written document is required before a trust can be valid. When the written document fails to include sufficient information to determine how a particular transaction is to be handled, state law will provide guidance. In other words, state law “fills-in-the-blanks” when certain provisions or powers are left out of the trust document.

103.26 **Finite Life** A trust cannot last forever. At some point, the legal and beneficial interests in assets must end. Most states have enacted a “rule against perpetuities” that sets a finite limit on the duration of a trust. In most states, a trust must terminate and distribute assets no later than 21 years after the death of the last to die of all identified beneficiaries who were living at the time the trust was created. Such beneficiaries will normally be the creator's grandchildren, so the trust will remain in existence until 21 years after the death of the last grandchild, and the assets thus will be distributed to the great-grandchildren. Of course, the trust can be terminated sooner, and the assets distributed to the grantor's grandchildren. States have taken three possible approaches to the rule against perpetuities. Some states have maintained the common law rule, discussed above. Other states have adopted the Uniform Statutory Rule against Perpetuities. Under the uniform provisions, a trust must either follow the common law rule or require that an interest vest within ninety years from the creation of the trust. To avoid any negative tax consequences, the trust cannot chose the longer of the two periods, but must select one period or the other. Finally, some states have abolished the rule. In states that have abolished the rule, a trust can conceivably last forever. States abolishing the rule often require the trust estate be freely transferable by the trustee.

103.27 The rule against perpetuities is both confusing and difficult to apply. This topic, including a listing of states that have no rule against perpetuities, is discussed in more detail in *PPC's Guide to Practical Estate Planning*.

Trust Protector

103.28 As discussed at paragraph 103.26, trusts can exist for a long time even if the rule against perpetuities applies. Where the rule has been eliminated, a trust can exist for several centuries. The benefits afforded by a trust exist due to applicable trust laws. Creditor protection, tax saving opportunities, and various other benefits created by forming a trust are available only so long as the trust laws support those benefits. Because laws can be changed by legislative action and court decisions and considering the potential longevity of a trust, it may be difficult to maintain a trust's original intent. To provide a measure of assurance that the intent of a trust is honored, many trusts are now being drafted to include a trust protector.

103.29 A trust protector is a person or entity with a special power over the trust or trustee. The protector has the power to change the trust terms in the event of law changes or changes in circumstances of the trust beneficiaries. Further, the trust protector can be given the power to remove and replace the trustee, to appoint trust assets to beneficiaries as the protector deems necessary, and even terminate the trust. The ultimate purpose in naming a trust protector is to allow the protector to make any trust changes necessary to ensure the primary objectives in establishing the trust are maintained. Moreover, the protector owes no fiduciary duty to the beneficiary, as the role of the protector is to assure the grantor's objectives in establishing the trust are upheld which might result in a beneficiary's benefit being reduced or eliminated and a change of trustee.

103.30 Some of the powers a trust protector might be given include the right or power to—

- Add, remove, and replace trustees.

- Add or remove beneficiaries.

- Approve or veto trust distributions.

- Change the situs and governing laws of the trust.

- Direct or veto investment decisions.

- Amend the trust's administrative powers.

- Amend the trust's dispositive powers.

- Consent to the exercise of a power of appointment.

- Approve trustee accountings.

- Terminate the trust.

103.31 While there are few limitations over who can be named a trust protector, when naming a trust protector, special consideration must be given based on the role of the trust protector. For example, a beneficiary cannot be named a trust protector. If a beneficiary is named a protector, the beneficiary would potentially possess a *general power of appointment*, which would cause the trust assets to be included in the beneficiary's gross estate. Further, the beneficiary's creditors would be able to attach the trust assets. Likewise, the trustee cannot be named a trust protector. Given the extensive powers of a protector, naming a trustee as a protector would create a conflict of interest between the duty to honor the intent of the trust and the trustee's fiduciary duties to the trust beneficiaries. The trust protector's allegiance is to the grantor, so the trust protector must be an independent party separate from the daily trust operations.

103.32 A trust protector must have a keen understanding of the trust laws and be aware of how changes in these laws might affect the trust's operations. By clearly stating the reasons for establishing the trust in the document, the trust protector has guidance on what specific trust laws should be monitored for possible changes.

103.33 Further, a trust protector should have the capacity to perform through the trust's term. Since a trust can potentially last for several decades, if not centuries, naming an individual would run counter to the purpose of the role of trust protector. Therefore, in practice, a law or accounting firm with an established expertise in trusts is most often appointed as the trust protector.

103.34 With the increased use and longevity of trusts, the ability to avoid potential negative consequences due to the trust's irrevocable nature has gained importance. Flexibility and relevance can be maintained by naming a trust protector. While naming a protector will increase the trust's administrative costs due to the protector's fee, assuring the trust will continue to achieve the grantor's objectives throughout the term generally justifies the additional costs.

Power and Duty of the Trustee

103.35 Most states have enacted laws that detail the powers, duties, and liabilities of a trustee when the trust document is silent concerning the ability of the trustee to act. The grantor has great flexibility in determining the extent of the trustee's powers. However, many grantors fail to adequately delineate the scope of the trustee's authority. When the grantor fails to state what the trustee can or cannot do in a particular area, the trustee must look to state statutes or case law to determine the actions he is allowed to take.

103.36 Generally, it is the trustee's duty to undertake any action necessary to carry out the trust's purposes and protect the trust property for the benefit of the beneficiaries. The extent of a trustee's powers is much broader today than originally allowed. Originally, trustees were substantially limited to holding and caring for property. Today, trustees can make a wide variety of decisions concerning every aspect of trust administration.

103.37 When interpreting the trust document to determine the extent of the trustee's powers, the courts will interpret the document to carry out the intent of the grantor by giving full weight to each word used. Further, the courts will not use state law to increase the powers of the trustee beyond those given in the trust document. The trustee is the only party entitled to administer the trust and normally does not have to ask permission from the beneficiaries before executing a particular transaction.

103.38 When managing the trust, the trustee must exercise the degree of care that persons of ordinary prudence, discretion and intelligence exercise in the management of their own affairs. In all transactions, the trustee must act with absolute good faith in dealing with the interest of a beneficiary. Due to the latitude in administrating a trust, the trustee must make sure that every act is beyond reproach. Liability issues for accountants acting as fiduciaries are discussed at section 605.

Lifecycle of a Trust

103.39 The lifecycle of a trust, including how it is created and funded and an overview of the trust process is discussed in the following paragraphs.

103.40 **How the Trust Is Created and Funded** A trust is created when a grantor has signed the trust instrument and the trust is funded (e.g., title to property or liquid assets are transferred to the trustee). When assets have been transferred and legal title has been placed in the trustee's name, a trust comes into existence. Merely signing a trust document is not sufficient to create a trust. A trustee must have assets under his control before a trust has legal effect. Although a trust document can be signed before the property is actually transferred into the trust, it does not exist until property is actually transferred into the trustee's name giving the trustee assets to manage.

103.41 **Overview of the Trust Process** Once assets have been placed in trust and title has been changed into the trustee's name (i.e., the trust has been created and funded), the trustee becomes responsible for managing those assets in accordance with the trust's provisions. A trustee must abide by the terms of the trust and must manage the assets for the beneficiaries' benefit. Effectively, the trustee enters into a fiduciary relationship with the beneficiaries. As a fiduciary, the trustee must always put the interest of the beneficiaries ahead of any personal interests.

103.42 A trustee cannot favor one set of beneficiaries over another. The interest of the income beneficiaries often is adversarial to those of the remaindermen. Unless the trust document gives the trustee the power to favor the interests of one set of beneficiaries over the other, a trustee must balance the interests of both groups of beneficiaries. In addition, a trustee cannot favor a single beneficiary within either group. All income beneficiaries are equal and must be treated equally, unless the trust document states otherwise. The primary purpose of a trust is to transfer property from the grantor to the beneficiaries. A trustee's responsibility is to assure that the property is properly managed and distributed according to the trust document without showing favoritism within a beneficiary class or between beneficiary classes.

Example 1-7: Management of the trust without favoritism.

Able, Baker, and Charles are income beneficiaries, while Randy and Rick are the remaindermen of a trust created by Glenn. Tom, the trustee, cannot administer the trust in a manner that would favor the income beneficiaries over the remaindermen. In addition, Tom cannot show favoritism to Able over Baker and Charles or favor Randy over Rick, unless the trust document expressly gives Tom the power to favor these beneficiaries over the others.

103.43 **Managing Trust Assets** Because the trustee is responsible for managing the trust assets, the trustee must adhere to established standards (as determined by statute and case law) in managing the trust assets. These standards were developed to protect the interests of the principal beneficiaries. As discussed further in Chapter 6, the Prudent Man Rule or the Prudent Investor Rule are used by most states when interpreting and applying laws governing fiduciaries. The prudent man rule generally focuses on income and principal preservation. In contrast, the prudent investor rule requires the fiduciary to use (or engage a qualified investment professional to use) modern portfolio theory, including the concepts of total return and total portfolio performance as well as the reality that inflation is a major threat to capital preservation. These rules, including recent changes, are discussed beginning at paragraphs 202.6 and 206.10.

103.44 **Allocating Activity between Principal and Income** During the year, a trust receives cash inflows from its investments. Also, cash outflows must be made to pay the expenses of the trust. Distributions are not considered outflows. These inflows and outflows must be allocated between the different beneficiaries. The income beneficiaries and the principal (remainder) beneficiaries have claims on the net assets, so determining the claims of the beneficiaries to the assets is one of the purposes of fiduciary accounting. It is the trustee's responsibility to properly account for the inflows and outflows and charge them against the claims of the beneficiaries. As discussed in Chapter 3, each set of beneficiaries has an equity account. The net equity account reflects the claim by that set of beneficiaries against the net assets of the trust.

103.45 Trust accounting is similar to the cash basis of accounting. Assets are only reflected in the trust's accounting records when the trustee has control over the assets. Once the trustee has control over the asset, it is recorded on the trust's accounting records and allocated to the beneficiaries equity accounts. The trustee can make distributions to the extent of the net equity account. If the trustee does not have what is called discretionary or sprinkling power, the trustee must distribute the accounting income annually to the income beneficiaries. A *discretionary power* allows the trustee to withhold distributions, but if a distribution is made, then similar distributions must be made to all similarly situated beneficiaries. A *sprinkling power* allows a trustee to differentiate between beneficiaries within a class of beneficiaries.

Example 1-8: Discretionary and sprinkling powers.

Able, Baker, and Charles are income beneficiaries. Tom, the trustee, has no discretionary or sprinkling powers. Tom must distribute the accounting income equally to Able, Baker, and Charles annually. If Tom has discretionary power, he may decide whether a distribution should be made. If Tom distributes $5,000 to Able, Tom must also distribute $5,000 to Baker and Charles, since all three are income beneficiaries. A sprinkling power would allow Tom to make a $5,000 distribution to Able without having to make a similar distribution to either Baker or Charles.

103.46 **Termination** Throughout trust administration, a trustee allocates the inflows and outflows between income and principal to determine the proper claim of the beneficiaries. Assets are bought and sold according to the overall needs of the trust. Distributions are made in accordance with the trust terms and the assets distributed are those that will not jeopardize the future operation of the trust. Once the final income beneficiary's right to distributions ends, the remaining trust assets are distributed to the principal (remainder) beneficiaries and the trust terminates. In some cases, a reasonable amount of assets will be set aside for payment of contingent liabilities and expenses other than claims of beneficiaries. If the distribution of the trust principal (corpus) is unreasonably delayed, the trust may be terminated for tax purposes after a reasonable time to complete the administration of the trust. Determining what is a “reasonable time” is subjective and depends on the relevant facts and circumstances.

103.47 During the trust term, the trustee prepares annual accountings and at termination, a final accounting is prepared. The final accounting usually includes the entire operation of the trust from creation until termination, so it may span several years. Accountings, including various types of accountings and presentation formats, are discussed in detail in Chapter 4. The accounting principles followed by trusts are discussed in Chapters 2 and 3.

Conservatorships and Guardianships

103.48 While anyone of any age can own property, not everyone can legally manage it. Due to age, mental, or some other legal incapacity, a person may be unable to buy, sell, or manage the property. To assist in the management of the property, a court will place the property in the hands of a guardian/conservator [3] (also referred to as a trustee) to manage all financial affairs until the incapacity is removed or the person dies. For example, upon the death or disability of a parent, a court will appoint a legal guardian of a minor's property. At death, the property would be transferred according to the probate laws based on whether or not the owner has a will. Although the guardian/conservator (trustee) holds legal title and must manage the property for the owner's benefit, the property is considered the owner's property. If the owner being a minor causes the legal incapacity, the resulting relationship is called a *guardianship*. If the owner is an adult, the relationship is called a *conservatorship*.

103.49 A guardian or conservator may also be appointed under a will. When it is necessary for a third party to manage property for a beneficiary, the creator of the will may either set up a trust managed by a trustee, or provide a guardian or conservator to manage the property. *PPC's Guide to Practical Estate Planning* discusses the reasons why legal guardianship arrangements normally are not a preferred vehicle for transfers to minors.

103.50 Regardless of whether a guardian or conservator is appointed, the relationship is the same. The owner cannot legally manage his or her property. To enable the owner to enjoy the benefits of the property, someone must be named to manage it for him. Guardianships and conservatorships are created by a court to place the title of the owner's property in the name of a person or institution that is legally competent to manage property. If not named pursuant to a will, the courts generally name someone who has a relationship with the owner and has the ability to manage property as the trustee. The guardian/conservator (trustee) is required to manage the property solely for the owner's benefit. Therefore, all benefits from the property belong to the owner. Periodic accountings are provided to the court to show how the property is being managed. When the owner is capable of managing the property, the guardianship or conservatorship is terminated and the title is transferred to the owner. In the case of minor children, the guardianship terminates when the minor reaches the age of majority (age 18 or 21, as determined under state law). The termination occurs regardless of the former minor's ability to manage the property or the amount of the property included in the guardianship.

103.51 Creation of either a guardianship or conservatorship occurs in a court proceeding, and although a trust relationship exists legally, a true trust is not created. The owner is the grantor and sole beneficiary of the trust. All economic interests, both present and future, belong to the owner. Thus, there is no need to separate transactions between principal and income. Unlike a trust, a guardianship or conservatorship is not a separate legal entity or taxpayer. Instead of filing a fiduciary income tax return, all income and deductions are shown on the personal tax return of the owner. In addition, the owner's social security number is used on all bank and brokerage accounts. Therefore, the creation and termination of the guardianship or conservatorship has no tax effect.

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[3] There are two types of guardians/conservators—of the *person* and of the *property*. Guardians/conservators of the person are parties that have been chosen to take personal care of minor children or other incapacitated individuals. The discussion in this *Guide* refers to guardians/conservators of the property.

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104 The Concept of Property

104.1 The fiduciary should be familiar with the different types of property (real and personal) and how they are treated in the administration of a fiduciary entity. The form of property ownership can determine how the property is administered and distributed. It also can affect who receives the property when there is no will. Many states provide for a difference in distribution for real property than for personal property in the event of intestacy. It is necessary to properly classify the property to determine who is to receive it.

Real Property

104.2 Real property (sometimes referred to as real estate) is permanently fixed in place. It includes land, buildings (residences, apartments, offices), and objects deemed permanently attached to land and buildings.

104.3 **Transfer of Real Property** The administration of an estate will most likely involve the transfer of real property. Ownership of real property is evidenced by *title*. A *deed* is the legal instrument used to transfer title to real property.

104.4 There are some key terms that are associated with the ownership and transfer of real property. The more common terms include:

a. *Deed.* A written, signed document showing evidence of ownership of real property. The deed must be recorded in the records of the county in which the real property is located. In order to be recordable, the signature of the transferor must be acknowledged by a notary public.

b. *Conveyance.* Any transfer by deed or will of title to real property from one party to another.

c. *Title.* The right to or evidence of ownership of real or personal property.

d. *Interest.* A right in real or personal property. This right may be less than the full ownership or title.

e. *Grant.* A transfer of title to real or personal property by deed or other instrument.

f. *Grantor.* The party who conveys real or personal property to another.

g. *Grantee*. The party to whom real or personal property is conveyed.

104.5 **Classifications of Ownership in Real Property** Real estate law refers to classifications of ownership in real property as “estates in real property.” These classifications are generally distinguished by the extent and duration of the owner's interest in the property.

104.6 <u>Fee Simple Estate</u>. Most real property is owned as a fee simple estate (sometimes referred to as fee simple absolute). A fee simple estate is held as an absolute, unqualified and unlimited interest in real property. It is not subject to any restriction, and the owner is entitled to all rights and privileges associated with the property, including the right to sell it, gift it, or transfer it by will.

104.7 <u>Life Estate or Term for Years</u>. A *life estate* in real property is an interest in the property that lasts for either the lifetime of the holder of the interest (the *life tenant*) or for the lifetime of another person. A term for years allows an individual the right to the use and occupancy of the real property for a specified period of time, not necessarily measured by a person's lifetime. On the death of the life tenant or other person whose life determines the length of the life estate (or the end of the term for years), the interest terminates and the property automatically passes to the remainderman designated in the conveyance. In the alternative, the property could revert to the grantor. Because title passes automatically upon the occurrence of an event (the death of the measuring life or the end of the term for years), the property is not subject to estate administration and is not subject to the risk of the creditors of the decedent. Note that if the property does revert to the grantor, then the value of the reversionary interest can be included in the gross estate (but not the probate estate) of the grantor, even though the life tenant is still alive (see IRC Sec. 2037).

104.8 <u>Remainder Interest</u>. A remainder interest is an interest in real property that provides for the use and occupancy of such property at the end of another person's life or at the end of a term for years. If the remainder interest is vested (certain to pass to the individual named as the life tenant), then it constitutes an interest that must be included in the gross estate of the remainderman for federal tax purposes if the remainderman dies before the life tenant.

Example 1-9: Creation and termination of life estate.

> John conveys Riverfarm to Tim for the life of Tim and the remainder to Fred. Tim has a life estate in Riverfarm based on his lifetime. Tim is the life tenant. Fred is the remainderman. When Tim dies, fee simple title to Riverfarm automatically vests in Fred without going through probate proceedings.

104.9 <u>Leasehold Estate</u>. A *leasehold estate* in real property is an interest in real property that grants the right to the use and occupancy of property for a term of years. In a leasehold, title generally does not transfer, and the grantor is considered the owner of the entire interest in the property. Typically, the right to the property is expressed in a specified term of years (i.e., a 10-year lease). Such an interest is created and terminated by its own terms. Leaseholds will include the standard landlord-tenant relationships under real estate law.

Personal Property

104.10 Personal property is movable property. It is considered everything subject to ownership that is not real property and includes both tangible and intangible property, such as money, stocks, bonds, life insurance proceeds, cars, and household furnishings. During estate administration, the personal representative will generally use personal property of the decedent first to obtain necessary funds to pay creditors. Most state statutes set out a priority list for the payment of debts, usually providing for payment first from residuary bequest personal property, then from residuary bequest real property, then from specific bequests of personal property, and finally from specific bequests of real property.

104.11 Personal property can be subdivided into two categories: (a) tangible—property that has a physical existence and can be touched (cars, clothes, boats, animals, furniture, jewelry, etc.) and (b) intangible—property that has no physical existence and cannot be touched. Examples of intangible property include cash, checking accounts, life insurance plans, and retirement plan benefits. The ownership or existence of intangible property is evidenced usually by a document such as a bank statement, a stock certificate, or a life insurance contract. Intangible property has little or no value in itself, but it establishes and represents the right to receive something of value.

Forms of Property Ownership

104.12 Ownership in property can take various forms. They range from one person who owns the entire interest in the property to two or more persons sharing concurrent ownership rights as co-owners or co-tenants. (The term tenant or tenancy is synonymous with owner or ownership.) The text is intended to introduce and briefly discuss the most common forms of property ownership. (See *PPC's Guide to Wealth Protection Strategies* for a thorough discussion of forms of property ownership.)

104.13 **Tenancy in Severalty (Individual Ownership)** *Tenancy in severalty* means that one person is the sole owner of the property. That owner has complete control and all the exclusive rights and privileges. He or she may transfer the property during lifetime or dispose of it at time of death by will.

104.14 **Concurrent Ownership** Concurrent ownership is an ownership interest in real or personal property that is shared by two or more persons. The most common forms are joint tenancy, tenancy in common, tenancy by the entirety, and community property.

104.15 Joint Tenancy. *Joint tenancy* is the ownership of property by two or more persons who obtain an undivided interest in the property by gift, purchase, will, or inheritance. A unique feature of joint tenancy is the *right of survivorship*. When one of the joint tenant's dies, the title automatically passes to the surviving tenants by operation of law, without the need for probate. Therefore, the transfer of title to such property is not governed by the will and the property is not subject to estate administration. The last surviving joint tenant is entitled to the entire property.

Example 1-10: Joint tenancy with right of survivorship.

Ben, Mary, and Ruth own Riverfarm as joint tenants with rights of survivorship. Each owns one-third of Riverfarm. Ben dies. Riverfarm automatically passes to Mary and Ruth outside of Ben's will. It is a nonprobate asset with respect to Ben's estate. Mary and Ruth will each own 50% of Riverfarm.

104.16 Joint tenants are entitled to equal use, enjoyment, control, and possession of the property since they have an equal and undivided interest. The undivided interest means that no joint tenant is considered to own a specific part of the property. Further, each joint tenant owns the same percentage ownership as the other joint tenants. If two people own a piece of property as joint tenants, each owns 50% of the property. If five people own a piece of property as joint tenants, each owns 20% of the property.

104.17 Joint tenancies are recognized in both common law and community property states. Each state has its own statutes to determine whether joint tenancy exists under the law. The states vary in the express language necessary to create it. Proper classification is important to determine if an asset is part of the probate estate or not, and ultimately who receives the asset after death. Joint tenancy property is not part of the probate estate. If an asset is held in joint tenancy, it automatically goes to the surviving co-tenants and is excluded from the probate estate. Often, a decedent will title a bank account in two names, so another person can write checks on the decedent's behalf. Merely having a bank account in two names does not mean the person who supplied the funds intended the other person to have the remaining funds at death. A convenience account is not joint tenancy property and would be included in the probate estate and pass by the will. Most arguments concerning whether a bank account was joint tenancy property or not center on who is entitled to the funds remaining in the account at death. Practitioners should consult with the estate attorney to determine the proper existence of joint tenancy.

104.18 Tenancy in Common. With *tenancy in common*, each tenant (owner) owns a separate and distinct fractional interest in the property and an undivided right to use, possess, and otherwise enjoy the entire property, subject to the rights of the other covenants to do the same. The tenant's interests may be equal or unequal, and each is entitled to share proportionately in any profits derived from the property. A tenancy in common can exist in either real property (real estate and improvements to real estate) or personal property (property other than real property, such as a bank account, jewelry, or an automobile). Tenancies in common are found in both common law and community property states. The distinction between a tenancy in common and a joint tenancy is that property owned by a tenant in common does not pass by operation of law to the other co-tenants upon the death of a co-tenant.

104.19 Each tenant in common may transfer an interest by gift, will, or sale. When a tenant in common dies, his or her interest in the property, passes in accordance with the terms of the will or by the laws of intestacy of the applicable state (i.e., it is a probate asset) (see paragraph 102.1). The decedent's interest does not automatically go to the surviving co-tenants. Therefore, the right of survivorship that accompanies a joint tenant interest does not exist with a tenant in common.

Example 1-11: Property held as tenancy in common.

John dies with a will. In his will, he gives a one-half interest in his valuable stamp collection to his brother, Tim, who is also a stamp collector. John gives the other one-half interest to his nephews, Bob and Pat equally, who are just starting their own collection. Tim, Bob, and Pat are co-owners of the stamp collection as tenants in common.

When Pat dies, his one-fourth interest in the stamp collection would be transferred according to his will if he has one or according to the laws of the state of Pat's domicile if he dies without a valid will. Pat's one-fourth interest in the stamp collection would not automatically pass to the other co-tenants (Bob and Tim).

104.20 Tenancy by the Entirety. *Tenancy by the entirety* is essentially a special form of joint tenancy that treats the husband and wife as one unit. It is only available to a husband and wife, and must be in writing. Each spouse has an equal, undivided interest in the property, meaning that each spouse may possess the entire property. The husband and wife must both join in any conveyance of the property; neither can sell, gift, nor otherwise sever the tenancy without the express written and signed consent of the other spouse. Property held in this manner is nonprobate property. (See *PPC's Guide to Wealth Protection Strategies* for a thorough discussion of all of the requirements to hold property in this form.)

104.21 Because of the restrictions on the transfer of property owned in tenancy by the entirety, some states have abolished this form of ownership as being against public policy. It is presently recognized in approximately half of the states.

104.22 Community Property. *Community property* is one of two systems of marital property law ownership in the United States. The other type is common law (also referred to as separate property). Unlike common law states, community property states treat all property acquired by a married couple during the marriage as being jointly owned in equal shares by the husband and wife (subject to certain exceptions). In this sense, it is similar to ownership as tenants in common. However, it is not governed by the name on the title. Even if only one spouse's name is on the title, it is treated as owned in equal shares by husband and wife, if it was acquired during the marriage.

104.23 There are currently nine states that have adopted this form of ownership by spouses: Texas, Louisiana, New Mexico, Arizona, California, Nevada, Washington, Idaho, and Wisconsin.

104.24 The community property laws of each state are set by their own statutes and vary among the states. The estate's attorney should be consulted for the applicable rules.

104.25 Under the community property theory, each spouse is considered to own an undivided half interest in all property acquired during marriage regardless of each spouse's contribution towards that property. Also, both spouses have the right to convey by will his or her half of the community property to whomever they choose, with no control over the other spouse's half of the property.

104.26 In a community property state, the personal representative of the estate may have to distinguish *separate property* from community property. Separate property includes property individually owned by the spouse prior to marriage and property acquired by a spouse during marriage by gift, will, or inheritance. It can also include personal injury awards of an individual, even if the recovery occurred during marriage. Certain income from separate property may also be that spouse's separate property, although the rules concerning treatment of income vary from state to state. Separate property generally remains separate if it is not commingled with community property. If the spouses agree in writing, they can change separate property into community property or community property in to separate property. Otherwise, all property acquired by either spouse during marriage is generally presumed to be community property.

104.27 In community property states a community versus separate property tracing is often needed for an estate. Practitioners can provide this valuable assistance to the personal representative. However, the estate's attorney should be consulted throughout the process to provide guidance of how to apply the applicable state community property laws.

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105 What Is GAAP?

105.1 Among the challenges facing practitioners involved with accounting for estates and trusts are:

- Understanding the purpose of fiduciary accounting and how it affects accounting conventions.

- Determining the appropriate accounting standards to follow due to a lack of specific standards addressing fiduciary accounting.

- Understanding how or when to apply fiduciary accounting principles in creating and maintaining the accounting records of an estate or trust.

GAAP and Fiduciary Entities

105.2 Perhaps the biggest issue related to accounting and reporting of fiduciary entities is—What is GAAP for estates and trusts? The Financial Accounting Standards Board (FASB) and Governmental Accounting Standards Board (GASB) are responsible for setting GAAP for for-profit, nonprofit, and governmental entities. Practitioners have usually spent years learning about such accounting principles and have experience in practice with these entities. However, practitioners are generally less familiar with estates and trusts and the determination of GAAP for fiduciary accounting is not as easy because:

- authoritative literature issued by the FASB and other nonauthoritative literature issued by the AICPA do not directly address fiduciary accounting, and

- the determination of how to account for an estate or trust normally depends upon, or is subject to, the proper interpretation of a governing document (the will or trust instrument) and the laws of the state [4] having jurisdiction.

GAAP and Other Bases of Accounting

105.3 Many accountants believe there is an adequate body of accounting knowledge that allows them to conclude that GAAP exists for fiduciary accounting. However, some accountants question the potential lack of consistency among fiduciary entities due to the ability of the governing document and varying state laws to establish different accounting treatments for various items. Since authoritative literature does not directly address fiduciary accounting, the authors believe accountants and fiduciaries have latitude when selecting the basis of accounting to use for fiduciary accounting purposes. Fiduciary entities may use any of the following bases of accounting:

- Generally accepted accounting principles (GAAP).
- Basis of accounting specified by the terms of an agreement.
- Cash basis.
- Tax basis.

105.4 However, the authors believe some choices of basis of accounting generally are more appropriate than others. Issues relating to accounting for fiduciary entities, including consideration of whether GAAP exists for such entities and consideration of other bases of accounting are discussed in detail in Chapter 3. That chapter discusses the purpose of and general issues that characterize fiduciary accounting, including differences from commercial accounting. In addition, Chapter 3 reviews the alternatives relating to selection of a basis of accounting, including a review of fiduciary accounting conventions that may be characterized as GAAP, and provides the authors' recommendations.

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[4] Each state has its own set of fiduciary accounting rules. While these rules are generally referred to as principal and income acts, they may be referred to by other names. In addition, state statutes (e.g., state probate code and trust law) often address fiduciary accounting and/or reporting issues. Principal and income acts, which provide guidance to fiduciaries on how receipts and disbursements should be allocated between principal and income, are discussed in detail in Chapter 2. While most states have adopted some form of the accounting conventions included in the Uniform Principal and

Income Act (UPIA), differences exist in the principal and income acts of the various states.

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106 Internet Websites of Interest to Practitioners Serving Estates and Trusts

106.1 As discussed in section 100, little information has been written on accounting and reporting for estates and trusts. This *Guide* provides practitioners with information on how to account for and report on estates and trusts. In addition, other PPC sources of guidance relating to estates and trusts are listed at paragraph 100.10. All of these PPC Guides are available online at **tax.thomsonreuters.com**. Useful information about estates and trusts may also be obtained at the Internet websites provided in Appendix 1E.

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107 Overview of This *Guide*

107.1 As mentioned in section 100, this *Guide* is designed for use by accountants and other practitioners who are involved in accounting for and/or the administration of estates and trusts. It is organized to provide users with an understanding of estates and trusts, accounting for and reporting on fiduciary entities, and issues surrounding serving as the fiduciary for such entities. The following paragraphs provide a brief summary of the topics discussed in each chapter of the *Guide*.

Fiduciary Accounting and the Allocation of Principal and Income

107.2 Chapter 2 of the *Guide* discusses fiduciary accounting including the relationship of fiduciary accounting to other principles. It addresses the 1931, 1962, and 1997 Uniform Principal and Income Acts; duties of trustees as to receipts and expenditures; components of fiduciary accounting income and principal; apportionment of income; charges against principal and income; and related topics. Chapter 2 also provides guidance on the rules for allocating inflows and outflows between income and principal (corpus).

Accounting for Estates and Trusts

107.3 Chapter 3 of the *Guide* discusses the purpose of and general issues that characterize fiduciary accounting, including differences from commercial accounting. In addition, Chapter 3 reviews the alternatives relating to selection of a basis of accounting, including a review of fiduciary accounting conventions that may be characterized as GAAP, and provides the authors' recommendations. It also provides comprehensive case studies that illustrate accounting for an estate and a trust from the beginning to the end of the administration period.

Presentation and Disclosure

107.4 Chapter 4 of the *Guide* discusses presentation and disclosure issues relating to preparation of fiduciary accountings. It addresses form and style considerations for several presentation formats, including “Summary of Account” and other similar financial presentations as well as “traditional” format financial presentations. Chapter 4 also provides guidance on when various formats should be used and provides illustrative financial presentations. In addition, this chapter provides guidance on disclosure issues for fiduciary financial presentations.

Reporting

107.5 Chapter 5 discusses preparation, compilation, review, and audit services that practitioners sometimes provide to estates and trusts. It addresses level of service issues, including the applicability of Statements on Standards for Accounting and Review Services (SSARS), Statements on Auditing Standards (SAS), and other authoritative literature. Chapter 5 provides example accountant and audit reports on financial presentations of estates and trusts. It also includes practice aids that can be used to assist in the performance of financial statement preparation and compilation engagements. Issues addressed in the chapter include reporting on GAAP, OCBOA, terms of an agreement, prescribed form, and other fiduciary financial presentations.

Accountants Acting as Fiduciaries

107.6 Chapter 6 provides guidance to accountants who are providing, or thinking of providing, fiduciary services. It addresses professional and ethical issues when providing fiduciary services, fiduciary guidelines and delegation clauses in the governing instrument, practitioner liability issues, and other issues facing accountants when they act a fiduciary for an estate or trust.