PASSING OF ACCOUNTS & FIDUCIARY ACCOUNTING

Reviewing Accounts: What Lawyers Need to Look For

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WHALEY ESTATE LITIGATION PARTNERS

Reviewing Accounts:

What lawyers need to look for – we will cover

- **Guidelines for distinguishing between income and capital**
- **How to conduct a thorough analysis – which numbers need to add up where?**
- **Common errors to watch out for**
- **What qualifies as inadequate accounting**

Introduction to Accounts

- Duty to maintain records – some delegation but ultimately trustee responsible to account in accordance with governing documents
- Governing document provides guidance
- Duty to act in good faith in the interest of all beneficiaries
- Trustee responsible re treatment of transactions

Distinguishing between income and capital

- Form of accounts, Rule 74.18(3) (separate as to income and capital – Rule states only required if governing document dictates but as a practice accounts in court format are generally always separate as to income and capital)
- Even hand rule between capital and income beneficiaries
- Account entries dealing with Capital and Income

What are Considered Capital Entries?

- What are capital entries?
  - Capital Receipts would be the realization of original assets and the profits/gains on the sale of any original assets or trustee investments.
  - Capital Disbursements would be related to the administration of the Estate and any capital losses (e.g. funeral expenses, debts, legal fees, legacies, etc.) Certain expenses could be split between capital and revenue at discretion of trustee (e.g. large repair or renovation to rental property)

What are Considered Revenue Entries?

- What are revenue entries?
  - Revenue Receipts would include income received on original assets and trustee investments (e.g. interest, rental income, *dividends,etc.)
  - Revenue disbursements would include any expenses associated with the earning of that income (e.g. investment management fees). Generally income tax would be a revenue disbursement, however, if tax is related to capital gains would be a capital disbursement
- Payments and benefits by corporations – *Form rule (not all dividends are revenue)

Receipts by corporations to shareholders

- Payments from corporations to their shareholders are **dividends**
- Whether a dividend is capital or income depends on the **form** of the dividend declared by the corporation **NOT** the **substance**
- This is called the "*form rule*"

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Capital/income dividend

- A rolling back of profits into the Company e.g.
  - Options to purchase shares
  - Payments to redeem or retract shares
  - Issue of new shares (e.g. stock dividends)

  These are treated as **capital** in the trustee's hands and recorded as such in the Accounts

Capital/income dividend

- A payment of business profits – whether cash or kind is considered **income** and recorded under Revenue Receipts in the Accounts
- The *form rule* is sometimes disregarded if it causes a particularly unjust result e.g. if a corporation is wound up and its entire assets are distributed by way of an ordinary dividend

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Capital beneficiary

- Concerned that assets invested are secure and that there is capital growth
- If task of investing is delegated to an agent – must be made pursuant to a written plan for investment property

Capital beneficiary – Account Review

- Identify any tasks delegated by trustee
  - Express provision in governing document
  - Nature, physical location and size of asset
  - Expertise of trustee *vis a vis* asset
  - Common business practice
- If agent used – review invoices/fees of agent (deductible from compensation?)

Capital beneficiary – Account Review

- Check whether investment policy undertaken was it reasonable and adhered to
- Check opening and closing balances – is there unexplained erosion of $$ or unacceptable growth rate – make enquiries
- If delegated to third party – did trustee monitor agent's performance

Income beneficiary

- Are income distributions mandatory or discretionary – are trustees to consider factors?
- To whom and when are income distributions to be made?
- Is trustee directed to prefer interests of one beneficiary over another?
- Are expenses allocated between capital/revenue?

HOW TO CONDUCT A THOROUGH ANALYSIS

Pre-Review

- Read the governing documents (Will/Codicil/Trust/Management Plan)
- Was there an earlier Order or Judgment that amended the governing document? If there is a previous Judgment on Passing of Accounts review carry forward amounts, including assets and investments.

Summary

- Start at the Summary page
  - Do the numbers add up?
  - If this is not the first accounting, check the carry forward balances
  - Check the closing balances (receipts/disbursements/investments) to ensure that they match the summary numbers
  - Does the total net amount of the capital and revenue accounts equal the investments and cash on deposit in bank accounts?

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Assets/Liabilities

Original Assets

- The Accounts should record the assets held at the beginning and end of the accounting period (if not the first passing, need to review original assets remaining at end of previous passing)

Liabilities

- Do the accounts include a list of the liabilities at the beginning and end of the accounting period?

Capital

Capital Account

- Receipts - When the original assets are realized, their receipt is recorded in capital receipts (can you track the sale/disposition of each asset?)
- Any capital gains/losses on original assets/investments?
- Expenses/disbursements, do they seem reasonable, do they have all supporting vouchers to review?
- Are the entries properly recorded in the capital account?

Revenue

Revenue Account

- Check the original asset and investment list to examine whether interest and dividends have been received in a timely fashion and recorded properly.
- Expenses/disbursements – reasonable? Supporting vouchers available?

Investments

Investment Account

- Does the investment account balance including the number of shares or units at the end of the accounting period? (should be straight receipt and disbursement of investments, any capital gain/loss or income on the investments to be recorded in capital or revenue)

Compensation

- Does the statement of compensation properly calculate compensation on the capital receipts and disbursements and revenue receipts and disbursements?
- Any pre-taking?
- Fees to be deducted from compensation?

Vouchers

- If necessary, request and review supporting vouchers

COMMON ERRORS TO WATCH OUT FOR

Tips and Traps

- Accuracy – check the math!
- Lack of Detail – incomplete information, missing assets or time periods
- Provisions of governing document not complied with e.g. budget in Management Plan
- Mutual funds – this asset/investment is commonly not recorded properly
- Un-compensable transactions not deducted prior to calculating compensation

WHAT QUALIFIES AS AN INADEQUATE ACCOUNTING

Inadequate Accounting

- Rule 74.18 sets out detailed rules for form of accounts, do they comply with Rule?
- Incomplete and inaccurate values of assets
- Missing details/transactions of concern to your client
- Lack of investments over long period of time (duty to convert – duty to keep even hand)
- Co-mingling of funds
- Missing vouchers/pre-taken compensation

Requirement to Account

- Executors and trustees have a duty to maintain continuous, comprehensive, detailed and accurate records of their management of assets. If the trustee chooses or is compelled to apply to court to pass accounts, the *Rules of Civil Procedure* mandate the format of the accounts (Rule 74.18). Trustee must have all vouchers available for inspection.

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Proper Accounting

Zimmerman v. Fenwick (indexed as Zimmerman v. McMichael) 2010 ONSC 2947

[para 34] A trustee must make a proper accounting as a condition precedent to being awarded compensation. Without a proper accounting, the court is unable to assess the conduct of the fiduciary and to determine the compensation to which he or she is entitled. Where a trustee is found to have failed to keep proper accounts and to have been grossly indifferent to his/her fiduciary obligations, he/she may be disentitled to compensation:

Widdifield on Executors and Trustees, above, at p. 13-7; Gibson (Re), [1930] M.J. No. 34, [1931] 1 D.L.R. 159 (C.A.); Picov Estate (Re), [2000] O.J. No. 682 (S.C.J.).

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Summary / Conclusion

THANK YOU!

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