FIDUCIARY ACCOUNTING PRINCIPLES: AN OVERVIEW

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Fiduciary Accounting

- Trustee owes a “duty to account”:
  1. Maintain trust records;
  2. Keep interested parties informed of transactions; and
  3. Pay required amounts to beneficiaries.
Fiduciary Accounting Income

- **What is it?**
  - Trust or estate income determined in accordance with the terms of the will/trust and applicable law.
  - *Different than taxable income.*

- **Why is it important?**
  - Trust says:
    - “All income to my wife for her lifetime, and, upon her death, the remainder to my children from a prior marriage.”
    - Thus, the wife’s rights in the trust property depend on what the trust settlor meant by “income”.
Income vs. Principal

- **Common law rule:**
  - **Income** = Income derived from the *use* of res, such as:
    - Dividends
    - Interest
    - Rental income
  - **Principal** = Property received as a *substitute* for the res, including proceeds from its sale.

- **Uniform Principal and Income Act:**
  - Codifies detailed allocation directives for receipts and disbursements; and
  - Grants the trustee discretion to make adjustments between income and principal.
Fiduciary accounting rules vary from state to state.

Most states have adopted a form of one of the three Uniform Principal and Income Acts.

NC adopted the ‘97 version of the UPIA effective January 1, 2004.

- Applies to every trust & estate existing or coming into existence after January 1, 2004, except as otherwise expressly provided in the governing instrument.
- Chapter 37A of the NC General Statutes.
General concepts:

- The fiduciary must administer the trust or estate in accordance with the terms of the trust or will, even if contrary to the UPIA.

- To the extent that the trust or will is silent, the UPIA controls.

- A trustee owes a duty of impartiality and must base decisions on what is fair and reasonable to all of the beneficiaries (unless clearly manifested otherwise in the trust).
Example

- Harold died survived by his wife, Maude. Harold and Maude each had 2 children from a prior marriage. Harold’s estate funds a lifetime trust for Maude qualifying for the marital deduction. Upon Maude’s death, the property remaining in Maude’s trust passes to Harold’s children in equal shares.

- There is an inherent conflict between Maude (the income beneficiary) and Harold’s children (the remaindermen).
Allocations Between Income and Principal

- Income in respect of decedent ("IRD"):  
  - Income earned during life but not received as of decedent’s death.  
    - i.e., final paycheck and accrued interest.  
  - IRD is treated as an asset owned at death, not income received during administration. N.C.G.S. 37A-3-302(b).
  
- Example:  
  - Harold owned a CD that had $50 of accrued interest at his death.  
  - If the estate subsequently receives $125 of interest, only $75 will be allocated to the estate’s income.  
  - The remaining $50 will be treated as a receipt of a principal asset.
Allocations Between Income and Principal

- **Initial receipts:**
  - Generally classified as principal assets.
  - Testamentary trusts or pour-over wills:
    - A beneficiary’s income interest begins on the decedent’s date of death, even though the trust isn’t funded immediately. N.C.G.S. 37A-3-301(b)(2).
  - Fiduciary acquisition value:
    - Fair market value as of decedent’s death.
UPIA Receipts Allocable to Income

- **Receipts from Entities: N.C.G.S. 37A-4-401**
  - Corporations, partnerships, limited liability companies, etc.
  - Generally allocated to income.
    - i.e., Dividends (but not reinvested dividends).
  - **Four exceptions:**
    1. Property other than money:
      - i.e., shares received through a stock dividend are treated as principal receipts.
    2. Money received for part or all of the trust’s interest in the entity;
      - i.e., proceeds from the sale of a principal asset.
3. Money received from a regulated investment company or real estate investment trust if the money is distributed as a capital gain dividend.

Example:

Maude’s marital trust receives $10,000 from a mutual fund in October 2014. The 1099-Div received in January 2015 reflects that $1,000 of the October 2014 distribution was a capital gain distribution.

The fiduciary must transfer $1,000 from income to principal to reflect the portion of the October distribution that is allocable to principal.
4. Money received in total or partial liquidation of the entity.
   A receipt is allocable to principal if:
   (i) the entity indicates that the distribution is a partial liquidating distribution, regardless of percentage it represents, or
   (ii) the distribution exceeds 20% of the entity’s gross assets, regardless of whether the entity identifies it as a partial liquidation.
A distribution will not be treated as a partial liquidation (principal) to the extent that the amount received by the trust does not exceed the income tax owed by the entity on the taxable income.

- N.C.G.S. 37A-4-401(e)

**Example:**

Maude’s marital trust is one of two partners in a XYZ Partnership. XYZ Partnership sells a portion of its underlying assets for $500,000, with a basis of $300,000, recognizing a $200,000 long-term capital gain. XYZ Partnership distributes $250,000 in cash to the marital trust.

- The trust reports $100,000 as long-term capital gain (50% of XYZ’s gain);
- $230,000 is allocated to the marital trust’s principal; and
- $20,000 is allocated to income.
  - (20% capital gains tax on $100,000, the marital trust’s share of the LTCG).
Business and other activities conducted by the trustee:

- A trustee may elect to treat trust property as a separate business activity (sole proprietorship).
  - (i.e., farming, timber, rental real estate management)
- Receipts and disbursements are accounted for separately.
- Business income can be retained for working capital by the business and does not have to be allocated. N.C.G.S. 37A-4-403.
**UPIA Receipts Allocable to Principal**

- **Shall allocate to principal**: N.C.G.S. 37A-4-404
  - Assets received as contributions to a trust.
  - Proceeds (or loss) from the sale of trust assets.
  - Proceeds of property taken by eminent domain
    - *(exception: where a beneficiary holds a mandatory income interest and a separate award is made for loss of income).*
  - All net income where there is no income beneficiary.
Other Receipts

- **Life insurance:** N.C.G.S. 37A-4-407(a)

  - **Death benefit** –
    - Lump sum proceeds = 100% is allocated to principal
    - Annuitized distributions = 10% is allocated to income and 90% is allocated to principal

  - **Dividends** –
    - If premiums are paid from income = income
    - If premiums are paid from principal = principal
Other Receipts

- **Property and casualty insurance proceeds:**
  - N.C.G.S. 37A-4-407(b)
  - If policy insures trust assets = principal
  - If policy insures against loss of occupancy or income = income
Other Receipts

- **Rental property:** N.C.G.S. 37A-4-405
  - Receipts are generally allocable to income.
  - **Exception:** Depreciation reserve:
    - Trustee may transfer amounts from income to principal to reimburse the principal account for economic loss due to property depreciation.
    - **Considerations:**
      - Trust duration (shorter duration = less chance of decline)
      - Yield (is the property yielding less/more than other forms of investments?)
      - Does the trust give preference to the income beneficiary?
Other Receipts

- **IRAs**: N.C.G.S. 37A-4-409
  - If entire account is withdrawn = principal
  - If the account is retained as an inherited IRA:
    - Annual required minimum distributions (“RMD”)
    - Trustee must allocate 10% of the RMD to income and the remaining 90% to principal.
  - **Exception**: IRA payable to trust qualifying for the marital deduction:
    - Trustee must allocate the IRA’s *internal* income to income, and any excess to principal.
Example:

Harold designated the marital trust established for Maude as the beneficiary of his IRA. The marital trust qualifies as a conduit trust (stretch payouts tied to Maude’s life expectancy) and for the marital deduction.

- The RMD must be withdrawn and paid to the trust.
- The Trustee must compute the IRA’s internal income.
- The IRA’s internal income from the IRA must be passed through the trust and be distributed to Maude.
- If the IRA’s internal income exceeds Maude’s distribution, Maude can require the trustee to allocate a portion of principal to income, ensuring her right to the IRA’s income.
Other Receipts

- **Timber**: N.C.G.S. 37A-4-412
  - Net receipts from the sale of timber are generally allocated to income.
  - Cost of replanting is charged against income.
  - **Exception**:
    - If a mandatory income interest exists, the trustee must determine whether the timber removed exceeds the estimated growth rate.
    - If the timber removed exceeds the growth rate, the UPIA allocates the excess to principal.
Disbursements
Interest expense on liabilities;
Income taxes attributable to income;
Property taxes;
Recurring insurance premiums covering the loss of a principal asset;
Expenses incurred in any matter that primarily concerns the income interest;
Ordinary repairs; and
Ordinary expenses in connection with the administrative, management or preservation of the property.
Income Disbursements (cont.)

- The income is charged with half of:
  - The trustee’s regular compensation;
  - The compensation paid to any investment advisor or custodial service provider; and
  - The expenses for accountings, judicial proceedings or other matters that involve both income and remainder interests.
    - (i.e., accounting fees and attorney’s fees, unless related to a legal action to protect the trust property)
The principal is charged with:

- The remaining half of the expenses set forth on the prior slide;
- Cost of investing and reinvesting in principal assets;
- Principal payments on debts;
- Insurance premiums not allocated to income;
- Taxes on gains or profits allocated to principal;
- Transfer taxes payable from trust assets;
- Costs related to environmental matters;
- Cost of preparing property for rental or sale; and
- Costs incurred in maintaining or defending any action to protect the property.
Transfers Between Income & Principal

- **Power to adjust: N.C.G.S. 37A-1-104**
  - The trustee has the power to perform adjustments between income and principal as needed to make appropriate present and future distributions.
    - Considerations:
      - Trust purpose; duration; needs; type of assets; tax consequences.

- **The trustee has the discretion to transfer amounts from income to principal for:**
  - Depreciation reserve (N.C.G.S. 37A-5-503);
  - Reimbursement for expenditures (N.C.G.S. 37A-5-504); and
    - i.e., an extraordinary repair properly payable from income where income is insufficient.
  - To establish a reserve for anticipated future disbursements.
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