

FIDUCIARY ACCOUNTING PRINCIPLES: AN OVERVIEW

J. Aaron Bennett

Carruthers & Roth, P.A.

Phone: 336-478-1105

E-mail: jab@crlaw.com



Fiduciary Accounting

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- **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

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□ 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

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- **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.**

Uniform Principal and Income Act (“UPIA”)

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- ❑ **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.**

UPIA (cont'd)

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□ 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

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- **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

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- 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

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- **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

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- **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.**

UPIA Receipts Allocable to Income (exceptions, cont'd)

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- **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.**

UPIA Receipts Allocable to Income (exceptions, cont'd)

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- **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.**

UPIA Receipts Allocable to Income (exceptions, cont.)

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- 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).

UPIA Receipts Allocable to Income

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- **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

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- **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

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- **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

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- **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

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- **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

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- **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.**

Other Receipts

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□ 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

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□ 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 the timber removed exceeds the estimated growth rate.

■ If the timber removed exceeds the growth rate, the UPIA allocates the excess to principal.

Disbursements

Income Disbursements N.C.G.S. 37A-5-501

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- ❑ 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.)

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- **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)**

Principal Disbursements N.C.G.S. 37A-5-502

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- **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

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- **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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