TRUST ACCOUNTING FOR ACCOUNTANTS

By: Geoffrey N. Taylor, Esq.

I. OVERVIEW

A. Duty to account.

1. Among the many duties a trustee owes to trust beneficiaries is the duty to maintain accurate books and records of the trust assets and its administration and to provide beneficiaries with periodic accountings or reports.

2. Accountings allow trust beneficiaries to stay informed about the administration of the trust and to protect their beneficial interests in the trust.

B. Nature of duty to account.

1. Trustees hold property for the benefit of third parties (i.e., the trust beneficiaries).

2. The trustee must act at all times for the sole benefit of the beneficiaries and act impartially as to those beneficiaries.

3. The trustee must keep trust beneficiaries reasonably informed.

C. General content of an accounting.

1. The beneficiaries of the trust are entitled to receive accountings (also called "reports") showing the assets, liabilities, receipts, and disbursements of a trust.

2. The purpose is to inform the beneficiaries regarding the activities of the trustee; e.g., how assets are being invested,

how income and principal are being distributed, and how expenses are being incurred.

3. The preparation and provision of a report can protect the trustee from breach of trust claims. See, e.g., MCL 700.7905(1)(a).

4. Although similar concepts are involved, trust accounting is not the same as financial or tax accounting.

5. A central distinction involves the differences between income beneficiaries and principal or remainder beneficiaries.

II. <u>SOURCE OF DUTY TO ACCOUNT</u>

A. Trust agreement.

1. Trust agreement specifies accounting requirements.

a. A trustee must first review the trust agreement to determine whether trust accounting provisions are included and, if so, what is required to be provided, to whom, and when.

b. "With respect to each trust established under this Trust Agreement, the Trustee shall, at least annually, render to each beneficiary of a trust who is currently entitled or eligible to receive a mandatory or discretionary distribution of income or principal from such trust a statement of account showing (i) the receipts, disbursements, and transactions involving the trust during the accounting period, (ii) an inventory of the trust property at the end of the accounting period reflecting the cost and market value of the assets to the extent reasonably available, (iii) the trust's liabilities, (iv) the source and amount of the Trustee's compensation, if any, and (v) any other disclosures required by applicable law. The statement shall be delivered as soon as practicable after the close of the accounting period or upon termination of the trust or resignation or removal of the Trustee. The Trustee may, but shall not be obligated to, provide an account statement to any other beneficiary."

2. Trust agreement provides the trustee is not required to account.

    a. The trust agreement may affirmatively state the trustee is not required to account.

    b. "In no event shall the trustee have any obligation to account to any beneficiary."

    c. However, regardless of what the trust agreement provides, under the Michigan Trust Code, a beneficiary is always entitled to receive relevant information about the trust property and to petition the probate court to order the trustee to provide statements of account and other information. See MCL 700.7105(2).

3. Trust agreement is silent regarding accountings.

    a. Occasionally, the trust agreement is silent regarding a trustee's obligation to account.

    b. In this case, the default provisions of MCL 700.7814(3) apply (see below).

B. Michigan Trust Code.

1. MCL 700.7814.

a. MCL 700.7814(1) sets the tone regarding a trustee's obligation to report to trust beneficiaries. "A trustee shall keep the qualified trust beneficiaries reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests. Unless unreasonable under the circumstances, a trustee shall promptly respond to a trust beneficiary's request for information related to the administration of the trust."

b. Absent a contrary provision of the trust agreement, MCL 700.7814(3) provides "[a] trustee shall send to the distributees or permissible distributees of trust income or principal, and to other qualified or nonqualified trust beneficiaries who request it, at least annually and at the termination of the trust, a report of the trust property, liabilities, receipts, and disbursements, including the source and amount of the trustee's compensation, a listing of the trust property and, if feasible, their respective market values."

c. Thus, the required components of a trustee's report under MCL 700.7814(3) are as follows:

   i. assets and their market values

   ii. liabilities

   iii. receipts

   iv. disbursements

   v. source and amount of trustee's compensation

d. MCL 700.7814(4), which cannot be modified or overridden by the terms of the trust agreement, empowers the probate court to compel the trustee to account. "If the terms of a trust direct that accounts and information be provided to less than all qualified trust beneficiaries, at the court's direction, the trustee shall provide statements of account and other information to persons excluded under the terms of the trust to the extent and in the manner the court directs."

e. Under MCL 700.7814(3), a trust beneficiary may waive the right to a trustee's report or other information otherwise required to be furnished. A trust beneficiary, with respect to future reports and other information, may withdraw a waiver previously given.

2. MCL 700.7103(g) – qualified trust beneficiary.

a. MCL 700.7814, and the Michigan Trust Code generally, focuses on the rights of "qualified trust beneficiaries."

b. Under MCL 700.7103(g), a "qualified trust beneficiary" means a trust beneficiary to whom one or more of the following apply on the date the trust beneficiary's qualification is determined:

i. The trust beneficiary is a distributee or permissible distributee of trust income or principal.

ii. The trust beneficiary would be a distributee or permissible distributee of trust income or principal if the interests of the distributees under the trust described in subparagraph i terminated on that date without causing the trust to terminate.

iii. The trust beneficiary would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date.

III. TRUST ACCOUNTING CONCEPTS

A. Income versus principal generally.

1. Income is the return the trust receives for the use of trust property.

2. Principal is the trust property itself.

B. Current versus remainder beneficiaries.

1. Trust has only current beneficiaries.

a. Where a trust provides for outright distributions on the death of the grantor, the trust accounting can be fairly straightforward.

b. E.g., “The trustee shall distribute $1,000 to Charity and the remaining assets to A.”

c. Here, the trustee simply reports to A (i) the trust assets and their market values on the grantor’s date of death, (ii) the trust liabilities, if any, (iii) trust receipts (e.g., income) and disbursements (e.g., expenses and the $1,000 distribution to Charity), and (iv) the source and amount of the trustee’s compensation, if any.

2. Trust has current and remainder beneficiaries.

a. What happens when a trust provides for a beneficiary to have a lifetime interest or an interest for a term of years, with the remainder to a different beneficiary?

b. The classic example is a marital trust. E.g., "The trustee shall distribute all income to Spouse for life and remainder to Child."

c. There is an inherent conflict between the nature of the interests of held by Spouse and Child. For example, Spouse wants the trustee to maximize current income rather than capital appreciation and wants expenses allocated to principal rather than income. Child wants exactly the opposite.

d. Personal circumstances can add significantly to that conflict (e.g., Spouse and Child are unrelated and hate each other).

e. Provisions of the trust can also add to the conflict (e.g., Spouse and Child each can receive distributions for health, maintenance, and support in accustomed manner of living during Spouse's lifetime).

f. In this situation, the manner in which the trustee allocates receipts and disbursements between income and principal may materially affect Spouse's and Child's interests.

C. Trust accounting income.

1. Trust accounting income (sometimes referred to as "fiduciary accounting income") is defined by the trust agreement, not federal tax law.

2. If or to the extent the trust agreement is silent, trust accounting income is determined under state law (e.g., the Michigan Uniform Principal and Income Act).

3. Trust accounting income is not the same as taxable income.

D. Michigan Uniform Principal and Income Act ("Act").

1. General.

a. The Act provides the rules that govern the allocation of receipts and disbursements to or between principal and income. MCL 555.501 et seq.

b. If the trust agreement contains provisions regarding allocations of receipts and/or disbursements to principal and/or income, the terms of the trust agreement control.

c. In the absence of contrary terms in the trust instrument, the provisions of the Act control (i.e., if or to the extent the trust agreement is silent, the Act provides the "default" rules).

d. The trust agreement often gives the trustee discretion regarding allocations, which may effectively override the default rules under the Act. "The Trustee shall have the power to determine what part of cash or other property received by it is income and what part is principal, and to determine what expenses and other charges, including Trustee's fees and disbursements, shall be a charge against principal and what against income; provided, however, that stock dividends, rights to subscribe for any stock or securities, or any profit or gain which may accrue from any sale, exchange or other disposition of any property or assets included in the Trust, shall not be determined to be income subject to distribution, but shall be determined to be principal and shall be added thereto and treated in all respects in the same manner as the original principal of the Trust estate after deduction therefrom as a charge against the same of all income taxes payable with respect thereto, and all losses sustained as a result of the sale, exchange or other disposition of assets and property comprising a part of the Trust estate shall be charged against principal and shall not be charged against the income of the Trust estate or reduce the amount of such income subject to distribution. All cash dividends except liquidating dividends shall be considered as income."

2. Income.

   a. The Act defines "income" as "money or property that a fiduciary receives as current return from a principal asset." MCL 555.502(d).

   b. The Act allocates the following receipts to income:

      i. Interest.

      ii. Money (other than liquidation proceeds) received from an entity, such as a corporation, partnership, or limited liability company (e.g., dividends and cash flow distributions).

      iii. Rent.

      iv. 10% of required minimum distributions from an IRA or qualified plan.

c. The Act allocates the following disbursements to income:

i. 50% of compensation paid to the trustee or any person providing investment advisory or custodial services.

ii. 50% of expenses for accountings, judicial proceedings, or other matters involving both income and remainder interests.

iii. Other ordinary expenses, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter than concerns primarily the income interest.

iv. Insurance premiums.

3. Principal.

a. The Act defines “principal” as “property held in trust for distribution to a remainder beneficiary when the trust terminates.” MCL 555.502(j).

b. The Act allocates the following receipts to principal:

i. Assets used to fund the trust and assets received from a payer under a contract naming the trust or the trustee as beneficiary.

ii. Money or other property received from the sale, exchange, liquidation, or change in form of a principal asset (e.g., capital gains).

iii. Life insurance proceeds.

iv. 90% of required minimum distributions from an IRA or qualified plan and all nonrequired distributions from an IRA or qualified plan.

v. Property other than money received from an entity.

vi. Money received from liquidation of an entity.

c. The Act allocates the following disbursements to principal:

i. The other 50% of compensation paid to the trustee or any person providing investment advisory or custodial services.

ii. The other 50% of expenses for accountings, judicial proceedings, or other matters involving both income and remainder interests.

iii. Debt principal payments.

iv. Expenses of a proceeding that concerns primarily trust principal, including a proceeding to construe the trust or to protect the trust or its property.

v. Estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust.

vi. Disbursements for environmental matters.

IV. <u>TRUST ACCOUNTINGS/REPORTS</u>

A. Form.

1. MCL 700.7814 does not prescribe a form for the accounting (referred to in the statutes as a "report").

2. However, probate courts will be familiar with the SCAO forms for estates, guardianships, and conservatorships, which are PC 583 Account of Fiduciary – Short Form and PC 584 Account of Fiduciary.

3. Cash method is generally used.

4. The goal is to present the information in a manner that can be easily understood by the beneficiaries. The beneficiaries need to receive all material facts necessary for them to protect their interests.

B. Content.

1. Inventory.

a. The inventory lists the trust assets as of the beginning of the accounting period and as of the end of the accounting period.

b. Provide the assets' carrying values/cost basis and fair market values (if feasible).

c. List any trust liabilities.

2. Statement of receipts and disbursements.

   a. Provide all receipts and disbursements, including the source and amount of the trustee's compensation, for the accounting period.

   b. For trusts with current and remainder beneficiaries, list trust income receipts and disbursements separately from trust principal receipts and disbursements.

C. Timing.

1. Generally, a fiduciary must prepare a report at least annually.

2. However, a court may require otherwise, so it is vital to review any applicable court order.

D. Providing reports can protect the trustee.

1. Default statute of limitations.

   a. A judicial proceeding by a trust beneficiary against a trustee for breach of trust must be commenced within 5 years after the first of the following to occur (i) the removal, resignation, or death of the trustee; (ii) the termination of the trust beneficiary's interest in the trust; or (iii) the termination of the trust.

   b. This is a long period for the trustee to look over his shoulder.

2. Shortened statute of limitations if report is provided.

   a. A trust beneficiary cannot commence a proceeding against a trustee for breach of trust more than 1 year after the date the trust beneficiary was sent a report that

(i) adequately disclosed the existence of a potential claim for breach of trust and (ii) informed the trust beneficiary of the time allowed for commencing a proceeding.

b. A trustee report adequately discloses the existence of a potential claim for breach of trust if it provides sufficient information so that the trust beneficiary knows of the potential claim or should have inquired into its existence.