

Trust Accounting and Taxation

Many individuals accumulate substantial amounts of wealth over their lifetimes. When they die, a large part of their assets is passed on to heirs through estates and trusts. It follows then that accurate, timely accounting information for trusts and estates is more important than ever. And, the Economic Growth and Tax Relief Reconciliation Act of 2001 (Tax Act 2001) placed broader demands on accounting records. In the hands of an experienced user, Financial Navigator (FN) is an effective software tool for performing the required tasks.

This presentation is for users experienced with FN, especially in tracking investments and recording receipts and disbursements. Further, while a background in partnership accounting is not required, it is helpful in understanding the advanced aspects of trust accounting.

This document consists of three parts:

- Trusts & Estates: Introduction
- Estate Accounting and Taxation
- Trust Accounting and Taxation (this document)

Trust Accounting

Trust accounting, as with any other accounting system, requires you to handle the three major parts correctly to have an effective system. Those parts are:

- Setting up the Chart of Accounts,
- Entering transactions, and
- Obtaining reports.

Many aspects of trust accounting with FN use the same techniques as are used for any other type of situation tracked with FN. The balance of this section deals with those areas that employ concepts unique to trust situations and may not be intuitively obvious to an experienced FN user.

Tax regulations divide trusts into two basic types: simple trusts and complex trusts. The provisions in the document that created the trust determine which type of trust it is.

Simple Trusts

A simple trust is one where the trust instrument requires that:

- All income is distributed to the beneficiaries in the year in which it is earned or shortly after the trust's yearend,
- No amounts are paid or set aside or used for charitable purposes, and
- No distributions from principal during the year. If a simple trust distributes principal, it is considered a complex trust for that year.

Complex Trusts

A complex trust is any trust that does not meet all three of the criteria of a simple trust defined above. This means the trust instrument allows the trust to accumulate income. This allows the trust to make distributions to beneficiaries based on their needs and not the income earned. This form of trust must pay income taxes on the income it earns. Therefore, distributions to beneficiaries are not deductions to the trust and do not represent taxable income to the beneficiaries.

Income and Principal Trusts

There are many different techniques that trust documents use to achieve their intended purpose for the management and distribution of the trust assets. For example, one of the more involved techniques stipulates that distributions to beneficiaries be made at the discretion of the trustee and based on the amount of income generated by the trust. Additionally, the trustee may distribute principal after the beneficiary reaches a certain age but not more than 5% of the total principal shall be distributed in one year. This requires that income and principal must be strictly accounted for separately.

Because income/principal trusts are one of the more involved types of trusts, the examples below illustrate how to use FN for sophisticated trust accounting. If your trust document uses different techniques, first understand the techniques presented here and then adapt them to your trust situation.

Taxable Year for a Trust

IRS regulations state that generally a trust must adopt a calendar year. This means that the calendar year used by FN works fine for a trust. As noted above, in certain situations, an election can be made to include the income for both the estate and related trust in one fiscal year income tax return.

Setting Up an Income/Principal Trust

For a trust that tracks income and principal separately, set up the Chart of Accounts using account qualifiers to designate separate accounts for income-related balances and principal-related balances. All accounts are then designated as either income or principal by using the corresponding account qualifier. For example, you need money market accounts to record the transactions and balances for each type of activity. They would appear as:

MONEY MARKET/INCO

MONEY MARKET/PRIN

This enables you to segregate the activity and to run reports for each type of activity separately.

The following additional items should be considered in setting up an accounting system for an estate or trust.

Tracking Tax Exempt Income/Expenses

Certain income may or may not be taxable to beneficiaries depending on their state of residence. For example, for state income tax purposes, municipal income from a California bond would probably be taxable to a North Carolina resident, but exempt for a California resident. Therefore, you must report the source of municipal income to the recipient beneficiaries so the proper decision can be made as how to report such income on their resident state income tax returns.

Also, if your trust earns income from municipal bonds or is in any way exempt from federal or state income taxes, you must take extra steps to collect the necessary information. In general, the expenses related to tax exempt income are not deductible for tax purposes. Therefore, you must track the related expenses and report them to beneficiaries as non-deductible.

Tracking Performance

The investment performance of trustees is more frequently being reviewed by beneficiaries and other interested parties. FN can be a valuable tool for reviewing the financial performance of a trustee.

Recording Income for an Income/Principal Trust

When entering transactions, it is important to decide which type of activity the transaction represents and enter it to the corresponding account.

Income Account Activity

As funds are received for investment income, record them as deposits to the MONEY MARKET/INCO account. Record distributions to beneficiaries for income as checks are written on this account. Therefore, at one time, the balance in this account indicates what is available for distribution.

Asset Sales

Transactions involving the purchase and sale of securities are principal-related activity. The transactions are entered in the MONEY MARKET/PRIN account. The balance of this account is considered a principal asset and is not available for the normal annual distribution of income.

Income Used for Assets

The situation becomes more complicated when income is received and not distributed. If the amount becomes large enough, the investment manager may not want to leave it in a money market account but invest it instead. This is generally allowed as long as the funds retain their identity as income funds and do not become co-mingled with principal funds.

To ensure that you can identify the asset as one purchased with income funds, simply put an account qualifier called /INCO on the account. Thereafter, when that asset is sold, you want to record that transaction in the account for MONEY MARKET/INCO even though it looks like a principal transaction.

You may want to set up and use a separate long-term capital gain account for income transactions. This ensures that your normal long-term gain account agrees with gains from principal transactions.

Allocating Income Among Beneficiaries

In certain circumstances, it is necessary to track equity account balances by a beneficiary. This uses the same concepts as tracking equity by partner in a partnership, but the account structure is slightly different. The accounts representing a beneficiary's undistributed share of the trust are liability accounts and not equity accounts. This means they represent an amount that is "due to" the beneficiaries and is, therefore, a payable of the trust.

This form of accounting is required in these cases:

- **Varying shares** — There is more than one beneficiary and the income is not divided evenly across the beneficiaries.
- **Varying distributions** — There is more than one beneficiary and the amount distributed every year to every beneficiary is not equal to the amount earned.
- **Income and corpus beneficiaries** — The trust document stipulates certain beneficiaries are to receive income and others are to receive part of the principal.

For example, the following automatic entry allocates long-term capital gains to the corpus beneficiaries as follows:

- 85% to A
- 15% to B

A CORPUS SHARE account can be set up as an expense account or as a contra-income account so that it offsets the capital gain income.

Automatic Entries				
Payee: Corpus Income		For: (19)		
Account	Action	Chg/Dep	Amount/Memo	
1 *** Multiple Distribution	Net Distribution Am	Chg		
2 CORPUS SHARE	Amt from Next Acco	Chg		
3 CAPITAL GAINS- LONG TERM	Account Balance	Chg		95,000.00
4 PARTNER B/INCOME	2nd Amount x Facto	Chg		.850000
5 PARTNER A/INCOME	Remaining Amount	Chg		
6	End Entries			
7				

Because this journal allocates capital gain based on the account balance, any previous corpus allocations should be deleted before making the entry. This avoids over-allocating capital gains. A second entry should be used for short-term gains.

The remaining income should be allocated to the income beneficiaries using a separate income allocation entry.

Allocating Expenses Against Income or Principal

Exercising your judgment is necessary in many aspects of trust and estate accounting. None is more important than in determining how to allocate expenses. Here are five resources to consider when making these decisions.

There are two sources of legal documents that can provide direction.

- **What does the IRS say?** — There are many situations in which the IRS has issued rulings on how expenses should be allocated. Because it can affect taxable income, they do not always leave it up to the person doing the accounting in all cases.
- **What's state law?** — Many states have statutes that deal with fiduciary accounting.

If the legal sources do not provide helpful direction, consider the following:

- **What's in the document?** — The will and trust documents may not state explicitly state how expenses should be handled, but will often give an indication of how the deceased would have wanted it to be handled.
- **What's standard practice?** — Often there is standard practice that has been followed in this or similar circumstances. You can assume the deceased or his or her attorney knew of this practice and expected it to be followed.
- **What does the attorney say?** — If no other sources are helpful and you must make a judgment call, consult with the attorney involved. It is better to have them give you their opinion before they see the results of a procedure you establish.

Trust Reporting

Trust reporting must meet four different objectives. There must be reports for:

- The trustee to show that the assets have been properly managed in accordance with the trust document.
- Beneficiaries to show they have received the proper distributions.
- Trust tax returns.
- State authorities to review trusts accountings to ensure that the fiduciaries are in compliance with their responsibilities.

The first three objectives are met through normal use of the FN reporting functions. Reports for trustees and beneficiaries can normally be prepared by using a well-designed system of account qualifiers. Because the Form 1041 required for trusts is very similar to the 1040, the normal tax reports can be used.

State Compliance Authorities

The reports required for state compliance authorities vary on a state-by-state basis so it is not possible for FN to produce one set of reports for use by all users. However, the overall requirements are often similar and require a report that lists all receipts and disbursements for the period under review. The disbursements must be segregated by those for expenses and those for distributions to beneficiaries.

To prepare this type of report, you should produce a Transaction Register report and write it to a file. Import the file in to a spreadsheet and sort the transactions by type. It may then be necessary to move certain transactions or groups of transactions within the list to meet the segregation requirement. Use the subtotaling function in the spreadsheet where needed.

How to Reach Us

Information and Sales: 800 468-FNFN (3636)
Fax: 650 962-0730
Web site: www.finnav.com
E-mail: customerservice@finnav.com
Technical Support: 650 962-8510
Hours: Monday - Friday 7:30 a.m. - 4:30 p.m. PT
Business Address: 254 Polaris Ave
..... Mountain View, CA 94043
Telephone: 650 962-0300

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