

# Trusts & Estates: Introduction

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 (this document)
- Estate Accounting and Taxation
- Trust Accounting and Taxation

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## Overview of Trust and Estate Accounting

Many aspects of accounting for a trust or estate appear as a combination of tracking investments for a normal individual investor and accounting for distributions for a partnership. The trust or estate receives investment income, makes distributions to beneficiaries similar to payments to any other type of payee. It holds investment assets and must periodically revalue them to market value to report to the trustee and to beneficiaries.

### **Wills and Trust Documents**

However, accounting for trust and estates is different primarily because different wills and trust documents have specific instructions to the administrator or trustee on how to handle many aspects of managing a trust or estate. This is especially true in the area of retaining or distributing the applicable income and assets.

### **Income and Principal**

Trust and estate accounting is also different in that it involves applying some concepts not found in other forms of accounting. The major example of this is in the concept of income and principal. This concept means that

two separate pools are formed within the trust: one to deal with the income earned by the assets, and the other to deal with the assets themselves. For example, receipts and expenditures are credited or charged to income or to principal, or partly to each after due consideration has been given to the respective interests of income beneficiaries and remaindermen.

### Different Beneficiaries

The basic objective of a trust or estate is to properly distribute cash or other assets to the persons who have different beneficial interests in the assets. A typical trust is designed to distribute *income* to one person or class of persons (income beneficiaries) for a stated period of time and then to distribute the *principal* (corpus) to another person or class of persons (remaindermen) after the expiration of the stated time period.

### Definitions

The following are the basic terms and concepts used in administering and accounting for trusts and estates.

- **Beneficiary** — A beneficiary is a person who receives distributions from a trust or estate. These distributions may take the form of cash, complete ownership of an asset such as shares of stock, or ownership of assets such as real estate. The beneficiaries become payees in the FN system.
- **Corpus** — Another term for principal. An income and principal trust can also be referred to as an income and corpus trust.
- **Distribution** — A distribution is a payment of funds or a transfer of an asset from a trust or estate to a beneficiary.
- **Estate** — An estate is the accounting entity that is created to account for a person's assets and liabilities when he or she dies. Often the will specifies that the assets of the estate should be transferred to one or more trusts. The estate is terminated when all the debts, including estate taxes, have been paid and all the assets have been distributed.
- **Fiduciary** — A person who is responsible for one or more roles regarding the management of a trust or estate.
- **Fiduciary Accounting** — The branch of accounting that deals with recording and reporting the activities of trust and estates.
- **Income** — The funds or other value generated by the assets held by the trust or estate. These funds are generally from dividends, interest, or rents received. This is the same definition as in traditional accounting. However, the concept has special applications in trust and estate accounting.
- **Principal** — The investments or other assets received by the trust or estate when it is originally created.
- **Probate** — Probate is the legal process of accounting for the assets and liabilities and then distributing the assets and paying off the liabilities of an estate. State law defines many aspects of this process.
- **Remaindermen** — A class of beneficiary who receives their distribution after another class of beneficiary has already received the distribution designated for them.

- **Trust** — This is a legal entity created by a will or other legal document that holds title to the assets regardless of whether the person who originally owned the assets is alive or not. How the assets are to be managed and distributed is controlled by the trust document.
- **Trustee** — The person designated to be responsible for managing a trust.
- **Will** — The document drawn up by the person during his or her lifetime that indicates how assets are to be distributed upon his or her death.

### Fiduciary Accounting Conventions

While there is not a set of specific principals, there are several broad conventions that apply to fiduciary accounting. Here are areas in which conventions are well established.

- **Assets Included** — Only assets under fiduciary's control are accounted for in accordance with governing instruments. All other assets are excluded. (*May be different from income tax basis statements.*)
- **Assets & Liabilities Not Included** — Assets are not recognized until cash or legal title passes. This means that those items such as accrued interest and dividends are not included. Liabilities (with certain exceptions in the case of an estate) and disbursements are not recognized until payment is made.
- **Financial Statements** — The principal financial statement is called a "Summary of Account," with subsidiary schedules, and begins with assets on hand at the beginning of the reporting period and ends with assets on hand at the end of the reporting period.
- **Asset Value** — Assets are reported in the Summary of Account at "fiduciary acquisition value." This is the market value on the date the asset is transferred to fiduciary or cost for assets purchased.

## Challenges of Trust and Estate Accounting

The fundamental objective of fiduciary accounting is to properly report. This becomes critical when different people have different beneficial interests in a trust or estate. Only through proper accounting can it be shown that the different beneficial interests were properly met. More specifically, the challenges of trust and estate accounting are:

- The accounting process must follow the management process and provide the required information.
- The accounting process must show that the required procedures for accounting for income were followed.
- The reports must be in a format which is specified by law or, at least, acceptable by the proper officials.

**Fiduciary  
Guidelines**

In order to properly record the financial activity of an estate or trust, the following factors must be considered:

- The provisions of the will or trust agreement,
- The provisions of state law, if not clearly defined in the will or trust agreement, and
- Reasonable and equitable proposals and solutions, if neither the will or trust agreement nor state law adequately address an issue.

For these reasons it is extremely important to understand the applicable provisions of the law or the trust document before starting to set up your accounting system on FN.

Fortunately, in some areas there is consistency across states. Every state follows one of these two sets of codes:

- The Uniform Principal and Income Act
- Or -
- The Revised Uniform Principal and Income Act

Check with your state to see which one applies and become familiar with the provisions of this act if you are handling a trust or estate that involves accounting for principal and income. Obviously, no estate or trust accounting work should be performed unless you have a clear understanding of all the provisions of the governing will and/or trust documents, as well as an understanding of applicable state trust accounting rules.

Bear in mind there are no authoritative AICPA pronouncements from the Financial Accounting Standards Board. What is considered as the "generally accepted accounting principles" must be practices based on the governing instrument together with state law and accepted practices or conventions.

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