Trust Accounting Issues

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Presented by

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Framework: Uniform Principal and Income Act (UPIA)

- Chapter 116 of the Texas Trust Code
- Current version enacted in 2003
- Provides default rules:
  "normal" allocation of receipts and expenses
- Provides exceptions to those rules:
  as provided in relevant instrument or
  by exercise of "power to adjust"

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Section 116.005: Power to Adjust

- Grants the trustee the power to adjust between principal and income under certain circumstances
- Response to Chapter 117 of the Trust Code: Uniform Prudent Investor Act (the "other" UPIA)
- Trustee may be investing in assets with high potential for appreciation, but which produce very little income, or in investments that produce high income but have little potential for appreciation
- Power to adjust remedies potential unfairness

Section 116.005: Power to Adjust

Trustee has the power to adjust under § 116.005 only if:

- Trustee manages the trust assets as a prudent investor (*i.e.*, as provided in Chapter 117 of the Texas Trust Code),
- Trust instrument describes the amount that may or must be distributed to a beneficiary by referring to trust income, and
- After applying other applicable rules in Chapter 116 or the trust instrument, Trustee is unable to administer trust estate impartially between the beneficiaries

Section 116.005: Power to Adjust

Trustee must consider various factors in exercising power:

- Nature, purpose, and expected duration of trust
- Intent of settlor
- Identity and circumstances of beneficiaries
- Needs for liquidity, regularity of income, and preservation/appreciation of capital

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Section 116.005: Power to Adjust

- Nature of trust assets and any use by beneficiary
- Relative amounts otherwise allocated to income and principal
- Whether trustee can/has invaded principal or accumulated income
- Economic conditions, including inflation and deflation
- Tax consequences of adjustment

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Section 116.005: Power to Adjust

Trustee expressly prohibited from exercising the power to adjust in certain situations, namely:

- where exercising the power would cause adverse tax consequences (for example, if it would jeopardize the federal estate or gift tax marital deduction),
- when the trustee is a beneficiary, or
- if power would cause trustee to be treated as owner of a portion of the trust for income tax purposes

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Case Study 1: Mortgaged Rental Property
Facts

- Trust requires distribution of all income to current beneficiary, and does not deviate from Trust Code rules for determining income
- Trust assets consist primarily of rental houses
- Houses are mortgaged
- Rental income sufficient to cover expenses and make interest and principal payments on mortgage, but not much excess (relative to cash flow)

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Case Study 1: Mortgaged Rental Property
Problem

- Problem: cash-flow mismatch
- Rent is classified as income under § 116.162
- Maintenance is charged against income under § 116.201(3)
- Interest payments are charged against income under § 116.201(3)
- But *principal* payments are charged against principal under § 116.202(a)(3)

Case Study 1: Mortgaged Rental Property
Problem, cont'd

- Trust document and Trust Code seem to require Trustee to distribute most rental income to beneficiary, deducting only regular expenses and interest payments
- Mortgage company requires Trustee to make principal payments, and remaining rental income provides only available cash
- Two different claims on the same income!

Case Study 1: Mortgaged Rental Property

One Answer: Shrug

- One possible answer: “You can’t do what you can’t do”
- Claims of a creditor take precedence over claims of a beneficiary
- Classify rent as income under normal rules, but use to pay principal anyway, because “have to”
- Not very satisfying answer, & may raise tax issues
- Couldn’t let this continue, would need to sell

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Case Study 1: Mortgaged Rental Property

Another Answer: Depreciation

- Another possible answer: reserve for depreciation
- Under § 116.203, may transfer to principal reasonable amount of net cash receipts from asset that is subject to depreciation (wear, tear, decay, corrosion, obsolescence)
- Houses are subject to depreciation (at least the structure is!), so this may help
- In early years of mortgage, principal payments may be less than depreciation

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Case Study 1: Mortgaged Rental Property

Another Answer: Separately Account as Business

- Another possible answer: separately account as "business or other activity"
- Under § 116.153, may separately account for "business or other activity" if that "is in the best interest of all the beneficiaries"
- May retain net cash receipts for working capital & "other reasonably foreseeable needs of the business or activity"
- But is this a "business"? What is an "activity"? What are "needs"? Is this really an intended purpose of § 116.153?

Case Study 1: Mortgaged Rental Property

Another Answer: Contribute to LLC

- Another possible answer: contribute houses to single-member LLC (with lender consent), account under entity rules
- No tax impact, single-member LLC is ignored
- Valid business purpose, generally don't want to own real estate outright (except for personal use)
- "Internal income" of entities is generally ignored for accounting purposes, & apply rules of § 116.151 to determine how receipts from entity are allocated

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Case Study 1: Mortgaged Rental Property

Another Answer: Contribute to LLC

Under § 116.151, receipts from entity are income except:

- Property other than money
- Money received in redemption of part or all of the trust's interest
- Money received in partial liquidation of the entity
- Money received from mutual fund or REIT that is a capital gain distribution for federal income tax purposes

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Case Study 1: Mortgaged Rental Property

Another Answer: Contribute to LLC

- But for the most part, we don't care how receipts from the entity are classified in this case
- What matters is that the internal cash flows of the entity are ignored
- Rent retained within the entity can be used to make interest *and* principal payments on mortgage, and what's left can be distributed by entity as income
- Beneficiary may still grumble, but trustee on sounder footing, and ameliorates some tax concerns

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Case Study 1: Mortgaged Rental Property

Another Answer: Power to Adjust

- Another possible answer: power to adjust
- Came to this last, and not by accident!
- Generally better to find a solution under the trust document or the default rules of Trust Code
- May or may not be rational to fear newfangled power to adjust – there be dragons here! – but conservative lawyering says not to use it unless you have a good reason

Case Study 1: Mortgaged Rental Property

Another Answer: Power to Adjust

- Under § 116.005(b)(4), one factor to consider in exercising the power to adjust is "the needs for liquidity"
- Here we have a clear need for liquidity to pay the mortgage
- Under § 116.005(b)(5), another factor is "the assets held in the trust," and whether they consist of financial assets or other assets
- The composition of trust assets here makes it difficult to administer the trust without adjusting

Case Study 1: Mortgaged Rental Property

Another Answer: Power to Adjust

- Note, though, that both of these factors are somewhat within the trustee's control
- The trustee could, and arguably should, sell the trust assets in due course (after making reasonable efforts to obtain a good price) to relieve liquidity problems
- Also, trust is currently undiversified, another compelling reason to seek to sell within a reasonable period
- All the approaches we have discussed are probably best considered interim/stopgap solutions

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Case Study 2: Family Limited Partnership
Facts

- QTIP trust requires distribution of all income to current beneficiary, and does not deviate from Trust Code rules for determining income
- No provision for distribution of principal
- Trust assets include an interest in a family limited partnership, which is invested primarily in minerals and income-producing real estate
- Trust also has some marketable securities

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Case Study 2: Family Limited Partnership
Facts

- Trust will be included in surviving spouse's estate, and estate tax expected to be due
- Internal income of FLP and income from other trust assets, together, would be enough to satisfy surviving spouse's needs
- But FLP is not making substantial distributions, so most of the FLP's internal income does not become trust income
- Spouse wants help!

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Case Study 2: Family Limited Partnership

One Answer: Increase FLP Distributions

- If general partner agrees, one possible approach would be to increase distributions from pship
- Distributions will generally be classified as income under § 116.151(b)
- But GP may not agree, and increasing distribution yield of the partnership may negatively affect any valuation discount
- FLP distributions also shift funds out of discounted entity

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Case Study 2: Family Limited Partnership

Another Answer: Exercise Power to Adjust

- Trustee could exercise power to adjust under § 116.005 by allocating increase in value of FLP interest to income
- Trustee would then use non-FLP assets to distribute this additional income to beneficiary
- Maintains assets in discounted form, does not require cooperation of FLP's general partner

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Case Study 2: Family Limited Partnership

Another Answer: Exercise Power to Adjust

- But wait! Didn't I say earlier that the power to adjust makes me nervous?
- § 116.176 provides more comfort here
- Under this section, if a marital deduction was allowed and the trust property is not productive of income, the spouse may require the trustee to make the property productive, sell, or exercise power to adjust under § 116.005
- Trustee probably can't sell or make productive

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Case Study 2: Family Limited Partnership
Another Answer: Exercise Power to Adjust

- So only remaining option is to exercise power to adjust, if surviving spouse asks
- And here she's asking!
- Upshot is § 116.176 reinforces § 116.005 in the special case where a marital trust has unproductive property
- Legislature is essentially telling us this is a case where exercise of power is appropriate, maybe required

Case Study 3: Income Tax Planning

Facts

- Trust created for beneficiary in low tax bracket (12% ordinary income, 0% capital gains)
- Trust requires distribution of all income to beneficiary, and also allows distributions of principal as Trustee determines to be in beneficiary's best interest
- Trustee distributes all ordinary income to beneficiary, and also generally distributes cash in an amount equal to any realized capital gains

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Case Study 3: Income Tax Planning
Problem

- Under default rules of Texas Trust Code, capital gains are allocated to principal (§ 116.161(2))
- Under the default rules of the Internal Revenue Code and Treasury regulations, capital gains are not included in the income that is "carried out" to a beneficiary by trust distributions (Treas. Reg. § 1.643(a)-3(a)
- Thus, capital gain may be taxed to trust rather than to beneficiary

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Case Study 3: Income Tax Planning
Solutions

Under Treas. Reg. § 1.643(a)-3(b), capital gains may be allocated to income if:

- Allocated to income under state law or the trust instrument,
- Allocated to corpus but treated consistently by fiduciary on books, records, and tax returns as part of distribution, or
- Allocated to corpus but actually distributed to beneficiary or utilized to determine amount that is distributed

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Case Study 3: Income Tax Planning
Allocated to Income Under State Law

- The first alternative (capital gain that is allocated to income under state law) is the easiest to understand
- Consider whether can justify exercise of power to adjust to classify as state-law income
- If so, exercising the power should cause the gain to be carried out to the beneficiary, accomplishing the tax objective

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Case Study 3: Income Tax Planning

Consistently Treated as Part of Distribution

- The second alternative (capital gain is consistently treated by Trustee as part of distribution) poses more issues
- Most importantly, it requires consistency, which may be undesirable
- Trustee may not always want to treat capital gain as part of distribution, because of beneficiary's circumstances or changing tax brackets

Case Study 3: Income Tax Planning

Actually Distributed or Used to Determine Amount Distributed

- The third alternative (capital gain is actually distributed or used to determine amount distributed) is more complex
- IRS interprets “actually distributed” narrowly, to refer to mandatory distributions upon a particular event
- IRS interprets “utilized . . . in determining the amount that is distributed” more liberally, but may still circumscribe fiduciary discretion

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