

Trust Accounting

Norman E. Richards, Esq.

Lampertius, Richards & Associates, PLC

31731 Northwestern Hwy., Ste. 170

Farmington Hills, Michigan 48334

(248) 538-5480 Phone

(248) 538-5481 Fax

www.jpllaw.com

nrichards@jpllaw.com

I. Introduction

One of the primary duties of the trustee of a trust is to provide accountings. This outline is focused upon accountings required from trustees of revocable trusts administered in Michigan. The Michigan Estate and Protected Individuals Code (EPIC) prescribes the trustee's duty to provide trust accountings during the life of the settlor and upon the settlor's incapacity and death. In addition to the statutory obligation, the trust instrument typically contains its own accounting obligations. EPIC allows the trust to override many of the default statutory accounting requirements. For this reason, the wise trustee will carefully review the trust document to ascertain the accounting obligations.

II. The Duty To Account

The trust accounting is the beneficiary's window into the proper administration of the trust. This allows the beneficiary to confirm that the trustee is fulfilling its fiduciary obligations, which is primarily to act for the benefit of the beneficiaries to the trust. Restatement, Second, Trusts, §172. It is widely accepted that the trustee has a strict duty to keep and render a full and accurate record and account of his trusteeship to the beneficiaries. 76 Am Jur 2d, Trusts, §405. It is a breach of the trustee's duty to fail to

provide an account to the beneficiaries as required by law. *Sloan v. Silberstein*, 2 Mich App 660, 141 NW 2d 332, (1966). Moreover, a trust cannot be drafted to completely relieve the trustee from a duty to maintain true and accurate records. “It is a strict duty of a trustee to keep and render a full and accurate record and accounting of his trusteeship to the cestui que trust, and the duty is strictly enforced by the courts.” *Raak v Raak*, 179 Mich App 786 (1988).

III. The Benefits of Accounting

Trust accountings are valuable to the trustee in several respects:

A. Limiting Trustee Liability. A primary benefit of an account is that it limits the time during which a legal challenge may be brought by a beneficiary against the trustee for breach of trust. The applicable statutes of limitations under EPIC are as follows:

1. One (1) year, absent fraud, from the date a beneficiary is sent a report that adequately discloses the existence of a potential claim for breach of trust and informs the beneficiary of the time allowed for commencing a proceeding. MCL 700.7307(1). While “report” is not specifically defined in EPIC, the word is equated with a statement of account rendered under MCL 700.7303(3)(d).
2. Five (5) years, absent fraud, if a report is not provided under MCL 700.7307(1) from the first of the following to occur:
 - a. The removal, resignation, or death of the trustee,
 - b. The termination of the beneficiary’s interest in the trust, or

c. The termination of the trust.

3. A beneficiary may also be barred from bringing suit by adjudication, consent, ratification, estoppel, or other limitations such as laches. The Doctrine of Laches is not based upon a fixed period of time. It is concerned principally with the question of the inequity of permitting a claim to be enforced and demands on whether the plaintiff has been wanting in due diligence. *Sloan v. Silberstein*, 2 Mich App 660, 141 NW 2d 332, (1966).

B. Substituting Probate Court Approval. Unless an interested party commences a proceeding, the administration of a trust proceeds expeditiously, consistent with the terms of the trust, free of judicial intervention, and without court order or other court action. MCL 700.7201(2). Pursuant to MCL 700.7307(1), if an account meets the requirements of an EPIC compliant accounting, a beneficiary who receives an account is limited to one year to bring an action against the trustee for breach of trust. This serves as a substitute to a formal probate proceeding to allow an account.

C. Pacifying Attentive Beneficiaries. EPIC requires beneficiaries to be notified of the existence of the trust no later than 28 days of the trustee's acceptance of trust, the right of the beneficiaries to request a copy of the trust and the right to request a statement of account (unless modified by the trust). MCL 700.7303(3). Invariably, regardless of a history of family

harmony, one or more beneficiaries will immediately demand information about the trust assets and an accounting. Unless there are valid reasons to withhold information, the trustee can pacify inquisitive or potentially hostile beneficiaries by providing an inventory and basic accounting as soon as possible.

IV. The Mechanics of Accounting

A. Tracking Trust Assets

1. **Inventory.** An accurate accounting cannot be prepared without an initial inventory of trust assets. Inventory must identify each asset over which the trustee has responsibility and its value on the date that the trustee assumed responsibility over the asset.

For many revocable trusts, the probate approved SCAO Inventory form, PC 577, will be sufficient to accurately identify and provide the appropriate evaluation. It is recommended to value assets using a method satisfactory for a Federal Estate Tax Return. This is especially true where there is significant real estate or capital assets. It is incumbent upon the advisor to insist upon accuracy with respect to inventories and accountings.

2. **Record Keeping.** Preparing a proper account requires good record keeping. Initially, the fiduciary should open a bank account for the trust under the trust's EIN (Employee Identification Number). Additionally, the trustee should maintain all statements from banks

and brokers, copies of trade slips issued after the purchase or sale of securities, receipts for all expenses and a ledger of trust distributions.

Where ongoing administration is anticipated that will require multiple filings of fiduciary tax returns, it is advisable for the person preparing the fiduciary tax returns to use a professional estate management and accounting system. Corporate fiduciaries are experienced in providing accounting and tax services and will properly maintain the accounting information according to their internal procedures and policies. One advantage of using a corporate fiduciary is that accountings can be produced rapidly and systematically and appropriate documentation is maintained.

When working with a non-corporate fiduciary it is advisable to sit down with the fiduciary and educate them in appropriate accounting basics. For those who are not electronically savvy, they should be taught how to maintain a checkbook, to segregate and keep receipts, and how to reconcile bank, brokerage and mutual fund account statements. The time spent coordinating appropriate bookkeeping and record keeping can avoid much frustration when it is time to prepare the account.

B. Principal and Income

Differentiating between principal and income is a central component of trust accounting procedure. Effective September 1, 2004, Michigan revised its Uniform Principal and Income Act. This statute is found at MCL 555.501 et seq. This act will be explored in more detail below. For purposes of this section, the following general observations are made regarding income and principal.

Both Michigan and Federal Law anticipate that the books and records for a trust will differentiate between principal and income. Michigan's new Uniform Principal and Income Act (UPIA) effective September 1, 2004 requires an allocation between principal and income subject to permissible allocation elections by the trustee. For federal tax purposes, Treas. Reg. §1.643(b)-1 requires that a trust's fiduciary accounting income will be determined under the terms of the governing instrument and applicable local law. However, trust provisions that fundamentally alter traditional accounting standards for income and principal will not be recognized.

1. **Income.** For trust accounting purposes, income means money or property that a fiduciary receives as a current return from a principal asset. It includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in Article 4 of UPIA. MCL 555.502(d). Common examples of income are rents, interest, and dividends.

2. **Principal.** For trust accounting purposes, “principal” is defined by UPIA to mean property held in trust for distribution to remainder beneficiaries when the trust terminates. MCL 555.502(j). Examples of receipts allocated to principal include assets received from a lifetime transfer, from a decedent’s estate or a trust with a terminating income interest, money received from the sale of a principal asset, proceeds from eminent domain, net income which cannot be distributed and proceeds from life insurance. Most capital gains are considered an item of principal.

There are several items that may be classified either as income or principal. The trustee, relying upon UPIA, will be able to determine how to allocate a particular receipt between income and principal. Items that may be allocated include:

- a. Royalties;
- b. Receipt from timber sales;
- c. Receipts from property subject to depletion; and
- d. Receipts from unproductive property.

In sum, the trustee and his counsel should be fully aware of the terms of the trust with respect to allocation of receipts. Additionally, UPIA should always be consulted and followed with respect to issues related to principal and income. MCL 700.7401(2)(u).

C. Reporting Requirements

1. **During Settlor's Lifetime.** While the settlor is alive, MCL 700.7303(1) and (2) govern the accounting requirements. The trustee is not required to inform a trust beneficiary of the trust and its administration unless the trust provides otherwise. If the settlor is incapacitated, the trustee may communicate with the settlor's designated agent.

If the settlor is incapacitated and has no designated agent, the trustee must keep beneficiaries who would qualify as a current trust beneficiary if the settlor were deceased reasonably informed of the trust and its administration.

The Probate Court has full authority, regardless of the trust terms, to order the trustee to keep other beneficiaries reasonably informed of the trust and its administration upon a showing of good cause. These provisions are consistent with Restatement, Third, Trusts §74.

2. **Upon The Settlor's Death.** Upon the settlor's death, the trustee's obligation to report consists of duties required by statute unless modified by the trust. A beneficiary's right to information depends upon whether they are classified by EPIC as a "Current Trust Beneficiary" or an "Interested Trust Beneficiary".

- a. *Interested trust beneficiary* is defined by MCL 700.1105(d) as a person that has one or more of the following interests in the trust:
 - i. Life estate.
 - ii. Eligible recipient of a mandatory or discretionary distribution by the trustee of income or principal.
 - iii. Eligible recipient of a mandatory or discretionary distribution by the trustee of income or principal upon termination of an interest of a person described in subparagraph (i) or (ii).
 - iv. Presently exercisable or testamentary general or special power of appointment.

- b. *Current trust beneficiary* is defined in MCL 700.1103(k) as a beneficiary about which either of the following is true:
 - i. The beneficiary has a current right to receive all or a portion of the income, if any, of the trust property.
 - ii. The beneficiary is currently eligible to receive all or a portion of a mandatory or discretionary distribution of income or principal.

- c. Unless modified by the trust, current trust beneficiaries must receive the following at least annually and on termination of the trust or upon the change of a beneficiary:

- i. A statement of account; and
 - ii. Information of the trust and its administration.
- d. Interested trust beneficiaries are entitled to receive the same information as a current interested beneficiary, but only upon reasonable request.
- e. The Probate Court has ultimate authority to direct that a trustee give a statement of account and other information to any beneficiary. MCL 700.7303(3)(b)(iii). Additionally, the trustee has discretion to provide information and accountings to any beneficiary.
- f. For charitable trusts, accounts should be filed with the Michigan Attorney General, Charitable Trust Section. MCL 14.256. A “Charitable Trust” is defined to include any relationship where a trustee holds property for a charitable purpose. MCL 14.252(b). This suggests that a revocable trust having a charity as a beneficiary requires accountings to be submitted to the Michigan Attorney General, Charitable Trust Section. According to the Office of the Attorney General’s website on the supervision of charitable trusts, the Attorney General is a necessary party to any court proceedings regarding determination, modification, or interpretation of a charitable trust. If, after

specific bequests, any portion of a will or living trust is to go to charity, or the will or living trust creates a charitable trust, the Attorney General's Office is an interested party and is to receive notification. It is advisable to contact that Attorney General, Charitable Trust Section, Department of Attorney General, P.O. Box 30214, Lansing, Michigan 48909, phone (517) 373-1152, if there is a charity receiving a distribution from the trust.

3. **Format.**

- a. **Accounts not filed in court.** There is no specified format required for a report or statement of account, unless a court specifies the content and manner of presentation. MCL 700.7303(3)(d). This section goes on to state that a statement of account is a report by the trustee that must, at a minimum, list the trust assets, if feasible giving their market values, the trust liabilities, receipts, and disbursements, and state the source and amount of the trustee's compensation. For complex accounts or accounts spanning several year, it is advisable to use a commercial estate management system.
- b. **Accounts filed in court.** There are benefits to filing a trust account in court that can outweigh potential costs. The one-

Trust Administration In Michigan
June 2, 2006

year statute of limitations is cut short. The trustee is assured that the account “adequately discloses the existence of a potential claim for breach of trust” for purposes of MCL 700.7307(1) such that the five-year statute of limitations does not apply.

If a decision is made to file the accounting with the Probate Court, it is advisable to contact the local court about whether there is a specific format requirement. Generally, a trust account filed in Probate Court should meet the requirements of a probate estate accounting for formal proceedings as identified in MCR 5.130(C)(2)(b). Note that a trust does not have to be registered before filing the petition to allow the account. MCR 5.501(C).

When working with the Probate Court, it is advisable to utilize a format in which they are familiar. Consider using, with slight modification, the Probate Court Forms PC 583 or PC 584, Account of Fiduciary. To the extent the trust is more complicated, these forms can be used as a cover sheet with references to attached exhibits. Note that if there are any gains or losses to be reported on the accounting, Form PC 584, must be used.

It is also advisable for fiduciary fees and attorney fees to be reported using a written description of services performed.

Finally, if at all possible, the trustee should obtain waivers and consents from all beneficiaries. SCAO Form PC 561 should be provided to each beneficiary along with the statement of account with a request to return the completed form to the trustee or trustee's counsel for filing with the court.

- c. **Compensation for the professional.** The accountant or attorney assisting the trustee in preparing accounts is entitled to reasonable compensation from the trustee. MCL 700.7401(2)(v)and(w). MCR 5.313 defines reasonableness by referring to MRPC 1.5(a). Additionally, the court rule requires:
 - i. The attorney and PR (trustee) must have a written fee agreement;
 - ii. The attorney must keep time records that identify the person performing the services, the date the services were performed, the amount of time expended in performing the services, and a brief description of the services;

- iii. The beneficiaries are notified of the engagement and provided a copy of the fee agreement together with information about frequency of payments, the right to request a copy of statements for services, and the right to object to attorney/accountant fees before the court.
4. **Implications of the Uniform Trust Code (UTC).** The Trustee's reporting obligations may be significantly changed if the proposed Michigan Trust Code (MTC) is codified. The Probate and Estate Planning Counsel has a sub-committee that is reviewing the Uniform Trust Code (UTC) in order to compile the statutory provisions to be introduced for the MTC. The emphasis behind this law is to provide more oversight of trust administration.

The UTC was completed in 2000 and has been enacted in 14 states and the District of Columbia. The UTC provisions regarding a trustee's duty to report are among the most controversial provisions of the UTC. The UTC preserves the principle that so long as the grantor is alive and has sufficient capacity, the trustee owes a duty exclusively to the grantor. Also, a trustee owes a duty to report to a beneficiary holding a power of withdrawal as if the beneficiary were the grantor, but only to the extent of the property subject to the power of withdrawal. UTC

Section 603 & Comment. This would allow reporting only to a surviving spouse beneficiary of a marital trust who has a power of withdrawal.

UTC §813 expands a trustee's common law duty to keep beneficiaries informed when UTC §603 does not apply. UTC distinguishes between "Qualified Beneficiaries" and "Non-Qualified Beneficiaries". Qualified Beneficiaries must be reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interest. Non-Qualified Beneficiaries (undefined by the UTC) are entitled to information only upon their specific request.

The trustee must notify qualifying beneficiaries of the trustee's acceptance of trust and the trustee's contact information within 60 days. With respect to an irrevocable trust or a revocable trust that has become irrevocable, the trustee must notify qualified beneficiaries of the trust's existence, the identity of the grantor, the right to request a copy of the trust instrument, and the right to a trustee's report. UTC §813.

Regular reporting is required under the UTC. A beneficiary may waive that requirement under UTC §813(d). Without a waiver, the trustee must furnish to the distributees or permissible distributees and to the other qualified or non-qualified

beneficiaries who request it, at least annually, a report of the trust's property, liabilities, receipts and disbursements including the source and the amount of the trustee's compensation. The report must also list the trust's assets and, if feasible, their market values. The report also must be sent when the trust terminates.

As noted above, a variety of states have adopted the UTC, and some of them have modified its terms. For instance, Utah has made all duties to report subject to override by the terms of the trust. It is note worthy that Michigan has already amended EPIC to adopt provisions of the UTC reflected in the Statute of Limitations. *See*, MCL 700.7307.

5. **Practical Suggestions.** Defining what is appropriate trust reporting is an attempt to balance the grantor's desire to limit information provided to the beneficiaries against the beneficiaries' need and right to obtain information necessary to protect their interests. In addition to the reports required by EPIC, there are other practical suggestions that will reduce tension between the trustee and the beneficiaries.
 - a. Consider frequent face-to-face meetings with the trust beneficiaries. It may be beneficial to have a family meeting soon after the trustee has accepted his fiduciary

role. Quarterly meetings would usually be sufficient as a supplement to telephone and written correspondence.

- b. Trustee should disclose the methods used to value assets for the inventory, computing fees and investing the assets of the trust.
- c. Trustee should provide a written summary of the trust terms and statement of the trustee's duties and responsibilities as well as the beneficiary's rights to request information as provided under EPIC and/or the trust and the remedies available to the beneficiary.
- d. If a beneficiary becomes disgruntled, it is advisable to refer them to a respected probate attorney who can provide appropriate counsel to the disgruntled beneficiary and temper unreasonable demands.
- e. Trustee should document all routine communications with trustee beneficiaries.

C. Uniform Principal And Income Act

As noted above, Michigan revised its Uniform Principal and Income Act on September 1, 2004. This law is codified at MCL 555.501 - 555.1005. The ability to allocate between income and principal places the trustee in tension with the current income beneficiary and the residual beneficiary that will receive the ultimate distribution of principal. This

tension will become most evident where there are continuing trusts for spouses, children, or present income beneficiaries of charitable remainder trust. Where there are significant assets in a trust, the trustee's decision on whether or not to allocate items to income, thereby affecting the amount available for distribution to an income beneficiary, will be significant.

REMEMBER: UPIA is a default law, which means that its provisions can be overruled by the trust document.

1. **Interaction with the Prudent Investor Act.** The Prudent Investor Act is also a default rule that may be expanded, restricted, eliminated, or otherwise altered by the provisions of the governing instrument MCL 700.1502(2). UPIA only applies if a trust is subject to the Prudent Investor Rule. MCL 555.504. The sophisticated planner may opt in or out of the Prudent Investor Act for a variety of purposes. Accordingly, the trust document must be carefully examined to determine whether or not the trust adopts the Prudent Investor Rule.
2. **The power to adjust.** If the trustee is subject to UPIA, the trustee must consider all relevant factors when deciding whether to exercise the power to adjust. The Michigan law did not incorporate the nine factors outlined in the Uniform Act. However, those factors are worth considering. They consist of:
 - a. The nature, purposes, and expected duration of the trust.

- b. The intent of the grantor.
- c. The identity and circumstances of the beneficiaries.
- d. The needs for liquidity, regulatory of income, and preservation and appreciation of capital.
- e. The assets held in the trust; the extent to which the assets consist of financial assets, interest in closely held enterprises, tangible and intangible personal property, or real property.
- f. The extent to which an asset is used by a beneficiary.
- g. Whether an asset was purchased by the trustee or received from the grantor.
- h. The net income allocated to income under the other sections of this chapter and the increases or decreases in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available.
- i. Whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.

- j. The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.
 - k. The anticipated tax consequences of an adjustment.
3. **Impermissible Adjustments.** A trustee may not make an adjustment if one or more of the following circumstances stated at MCL 555.504(4) would exist:
- a. Diminish the income interest of a spouse's income interest qualifying for a marital deduction.
 - b. Reduce the actuarial value of an income interest.
 - c. Change the amount payable to beneficiary under a fixed annuity amount or fixed fraction of assets.
 - e. Diminish the amount permanently set aside for a charitable purpose (charitable deduction).
 - f. Result in a person being treated as the owner (grantor) for income tax purposes.
 - g. Cause inclusion in the estate of a person having power to remove and/or appoint a fiduciary.
 - h. The fiduciary is a beneficiary.
 - i. The fiduciary would benefit directly or indirectly.
4. **Summary of UPIA Provisions.** It is beyond the scope of this outline to provide a detailed analysis of UPIA's provisions. The

reader is provided an overview with some notations of items of interest to the author.

a. UPIA Article 2 – duties at death/termination of trust.

- i. The fiduciary must first determine net income and principal receipts that accompany property specifically given to a beneficiary. The remaining net income is then allocated among beneficiaries subject to various adjustments.
- ii. Administrative expenses may be paid from principal or income. Expenses paid from property subject to marital or charitable deduction may be taken only to the extent allowed for “estate management” expenses under the *Hubert* regulations.
- iii. A pecuniary gift also includes interest as provided for by local law unless otherwise modified by the trust.

b. UPIA Article 3 – beginning and ending of income interests.

- i. An income interest begins on the date specified by the trust, the date the asset was transferred to the trust, or the date of the settlor’s death.

- ii. An income interest ends the day before the income beneficiary dies.
- iii. Note that QTIP trusts usually prevent stub income from being paid to the surviving spouse. A trust subject to UPIA must pay the stub income to the spouse unless careful drafting specifically remedies this situation.
- iv. Undistributed income is paid to a mandatory income beneficiary's estate. However, if the deceased mandatory income beneficiary had a power to revoke more than 5% of the trust, the undistributed income on that portion must be added to principal.
- v. An annuity or unitrust amount must be prorated through the final payment or date of death.

c. UPIA Article 4 – allocation of receipts from entities, etc.

- i. Entities include business interests. Cash (dividends, distributions) is allocated to income. Liquidation proceeds go to principal.
- ii. Article 4 deals with a variety of situations including:
 - Distributions from trusts and estates

- Receipts from rental properties
- Life insurance proceeds
- Receipts from qualified plans (Note that under UPIA qualified plan payments are allocated 10% to income and 90% to principal. This raises significant issues for trusts with conduit provisions for qualified plans because for a trust to qualify as a designated beneficiary all distributions must go to a designated beneficiary. This cannot be accomplished if 90% must be retained for principal. For a trust with conduit provisions, consider opting out of UPIA for purposes of distributions from qualified plans.)
- Receipts from liquidation of assets
- Receipts from mineral/natural resources
- Receipts from timber
- Receipts from derivatives and options
- Receipts from asset-backed securities

d. UPIA Article 5 – allocation of disbursements.

Trust Administration In Michigan
June 2, 2006

- i. Disbursements for trustee fees, accounting fees, attorney fees, and judicial proceedings are allocated $\frac{1}{2}$ to income and $\frac{1}{2}$ to principal.
- ii. Disbursements allocated entirely to income include ordinary administration expenses, taxes regularly assessed against principal assets (e.g. real estate taxes), and insurance premiums to cover loss of assets or the income from assets.
- iii. Disbursements allocated entirely to principal include principal debt payments, estate and transfer taxes, environmental expenses, and expenses primarily concerning a principal asset, including construing the trust or protecting trust assets.