

Fiduciary Accounting Puts the “Trust” in Trust Administration

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You place a lot of confidence in your trustee when it comes to the current management and future distribution of your wealth. But even the most well-intentioned fiduciary can inadvertently put your wealth at risk if they do not understand the nuances of the applicable Surrogate or Probate Court rules in your state.

Considering the amount of discretion given to a trustee, there is a lot of room for error in trust administration, particularly in the way expenses are allocated to the income and principal categories. Improper allocations could have a significant impact on the amount of wealth that is transferred to your beneficiaries and cause your true wishes to be left unfulfilled.

Generally speaking, the “income” category within a trust contains the funding (money or property) that the trust receives from a principal asset. Related expenses that are typically allocated 100% to this category include income taxes, accounting fees related to tax preparation, and expenses related directly to income.

The “principal” portion of the trust typically refers to the initial funding of the trust; funds received from the sale, exchange or liquidation of a principal asset; and all non-income. Expense allocations to this category can include debt payments, expenses for accountings and judicial proceedings, life insurance premiums and estate, inheritance and other transfer taxes.



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Other expenses are allocated across both categories according to state law. Most states have adopted a form of the federal Uniform Principal and Income Act (UPIA), which provides trustees across the country with consistent standards for allocating trust funds. Florida adopted the standard in 2002 through the enactment of the Florida Uniform Principal and Income Act (FUPIA).

Even among the 39 states that have adopted the UPIA, local rules still vary widely.

Compare Florida and New York, for example. Allocation rules differ in several major areas, such as:

• **Investment Advisory and Bank Fees.** In Florida, investment advisory fees and bank fees are allocated 50/50 between

principal and income, whereas in New York they are 2/3 and 1/3, respectively.

• **Legal Fees.** Florida dictates that legal fees be split evenly between principal and income, while New York considers 100% of legal fees to be principal expenses.

• **Trustee Commission Fees.** If the trustee takes a commission, the amount is split 50/50 between principal and income in Florida. In New York, commission fees are split 2/3 to principal and 1/3 to income.

• **Trustee Commission Calculations.** Trustee commissions are not set forth specifically by the FUPIA, which addresses them vaguely: “trustee is entitled to compensation that is reasonable under the circumstances.” New York’s Estates, Powers and Trusts Law (EPTL), on the other hand, sets forth very specific guidelines and thresholds for trustee and executor commissions.

When expenses are allocated incorrectly, the total distribution of the funds could fall far short of your original intentions. For example, we recently represented a grantor who established a marital trust to provide his spouse with income over the course of many years. Due to misallocation of the funds between the principal and income categories, the spouse received significantly less of the funds than she should have. The trustees making the decision on the allocation of expenses were the residuary beneficiaries (the kids) – you can see the

issue here!

It is important to keep in mind that the applicable state rules only apply to a trust based on its legal situs. If your trust was established in another state, it is still subject to the rules of that state even after you have changed residency, unless the legal situs of the trust is changed.

The best way for you and your trustee to ensure accurate allocation of expenses is through annual trust accountings, which provide a detailed account of the opening asset balance, current principal and income balance, gains and losses, sales, expenses, trustee commissions and other activities at any given point in time.

In addition to increasing the transparency of activities within the trust, other benefits include increased efficiency and accuracy of documentation that will be required in the administration process and reduced risk of litigation for the trustee.

Proactive and precise records are key to fulfilling the grantor’s wishes, minimizing the fiduciary’s liabilities and protecting the beneficiaries’ best interests.

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