

Fiduciary accounting treatment of entity distributions

The rules surrounding the treatment of taxable income and distributions from passthrough entities for fiduciary accounting purposes are confusing.

By Donita Joseph, CPA, MBT
Guest Contributor

When a trust or estate receives income from a passthrough entity, we do not apply general accounting and income principals; instead we must apply the fiduciary accounting rules.

This process is complicated by the fact that the rules have changed over time. Last year, California adopted §505 of the Uniform Principal and Income Act, which further complicates the treatment of distributions from entities to a trust.

Many practitioners may not be aware of these changes and the questions that may come up when the new rules are applied.

Also, as tax practitioners, we are accustomed to adjusting the tax basis of an entity by using the income and deduction items reported on the Form K-1. We may increase tax basis by contributions and income and decrease tax basis by deductions and distributions.

This is not how fiduciary accounting income (FAI) is determined, thus, it is not how trust distributions to trust beneficiaries of entity income are determined.

General rule

Under California Probate Code §16350, cash distributions from entities are treated as income.

Principal distributions come about when you have:

- Property distributed other than money;
- Money received in a distribution or series of related distributions in exchange for part or all of the trust's interest in the entity;
- Money received in total or partial liquidation of the entity; or
- Money distributed as a capital gain distribution from a regulated investment company or Real Estate Investment Trust (REIT).

Note: Money is considered distributed in partial liquidation if the distributions received by all of the owners collectively exceed 20% of the entity's gross assets, or if the entity indicates that it is a partial liquidation.

Practical application

The examples below show us how to calculate the amount to be distributed to the beneficiary, but in order to do these calculations, the Form K-1 from the passthrough entity owned by the trust is needed.

Suppose the entity distributes the \$75,000 in November 2010, but the K-1 is not received until April 15, 2011. Worse yet, what if the K-1 is not received until September 15, 2011? How do you determine the breakdown between income and principal when the distribution is received?

If you know that the distribution from the entity will be greater than or equal to the taxable income, there would not be an issue. The cash distribution would all be allocated to income.

There is little guidance, however, if the distribution will be less than taxable income. One approach might be to estimate the

correct allocations to income and principal and then make an adjustment to income and principal when the Form K-1 is received.

Some might suggest that the entire distribution be allocated to principal until the K-1 is received. This could cause a problem with complex trusts required to meet the 65-day rule for distributions because the K-1 might not be received until after the 65 days have passed. For a simple trust this would not be an issue. However, beneficiaries might object to the delay in their distributions if the entire amount is allocated to principal until the K-1 is received.

The narrative in the Uniform Principal and Income Act suggests that "If a trustee determines that it is appropriate to do so, it should consider exercising the discretion granted in UPIA §506 to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under UPIA §104 to the extent that it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments." ☹

About the author

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Treatment of distributions

Following are various examples of the treatment of distributions. All of the examples are for simple trusts required to distribute FAI to the beneficiary.

Example 1 - No distribution, but entity has taxable income

No entity income will be distributed to the beneficiary, so the trust must pay the income tax on the entity income. The taxes paid by the trust will be paid from principal of the trust.

Example 2 - Distribution from entity is less than the income per the Form K-1 and less than the tax owed on the entity income

Assume the entity has \$100,000 taxable income per the K-1. Also assume that the trust is in the 35% tax bracket.

The entity makes a cash distribution of \$25,000 to the trust.

The entire \$25,000 distributed to the trust will be allocated to principal and therefore would not be included in FAI. The \$35,000 needed to pay the income tax by the trust would be paid from trust principal.

Distributions, continued from page 78**Example 3 - Distribution from entity = taxes due on the entity income**

Again assume the entity has \$100,000 taxable income per the K-1, and the trust is in the 35% tax bracket. However, in this case the entity distributes \$35,000.

Here again, none of the distribution from the entity will be included in FAI. It will all be allocated to principal because the trust will need the funds to pay the income tax on the \$100,000 of taxable income.

Example 4 - Distribution from entity is greater than taxes owed on the entity income, but less than the entity taxable income

Here is where it gets complicated and the discussion in the Uniform Principal and Income Act suggests using an algebraic formula to determine the amount to be distributed to the trust's income beneficiary.

Again assume the entity has \$100,000 taxable income per the K-1, and the trust is in the 35% tax bracket. But, with a distribution of \$75,000 from the entity, the amount payable to the trust beneficiary would be \$61,538, calculated as follows:

$$\text{Distribution to income beneficiary} = \frac{C - (R \times K)}{(1 - R)}$$

C = Cash paid by the entity to the trust, R = Tax rate on income, K = Passthrough entity's K - 1 taxable income

Based on the above formula, the beneficiary distribution would be \$61,538

$$\$61,538 = \frac{\$75,000 - (.35 \times \$100,000)}{(1 - .35)}$$

The amount left in the trust will be the amount needed to pay the tax at the trust level.

| | |
|--------------------------|----------------------------------|
| Taxable income per K-1 | \$100,000 |
| Payment to beneficiary | <u>(\$ 61,538)</u> |
| Trust taxable income | \$ 38,462 |
| | <u>× 35% tax rate</u> |
| | \$ 13,462 Allocated to principal |
| Partnership distribution | \$ 75,000 |
| Trust tax liability | <u>(\$ 13,462)</u> |
| Payment to beneficiary | \$ 61,538 Allocated to income |

In this example if the trust was a complex trust (not required to distribute the income) and the \$75,000 was retained by the trust, the total tax payable by the trust would be \$35,000. (\$13,462 would be deducted from principal, and \$21,538 would be deducted from income.)

Example 5 - Distribution from entity is greater than taxes owed on the entity income, but less than the entity taxable income, and taxable income includes capital gain income

Again assume the entity has \$100,000 taxable income per the K-1, and the trust is in the 35% tax bracket. However, in this case the taxable income is comprised of \$80,000 ordinary income and \$20,000 capital gain.

The formula in this case would be:

$$\text{Distribution to income beneficiary} = C - G - \frac{(R \times K)}{(1 - R)}$$

G = trust's capital gains tax liability

Based on this algebraic formula, the beneficiary distribution would be \$67,692.

$$\frac{\$67,692 = \$75,000 - \$3,000 - (.35 \times \$80,000)}{1 - .35}$$

| | |
|------------------------------|---------------------------------|
| Taxable income per K-1 | \$100,000 |
| Payment to beneficiary | <u>(\$ 67,692)</u> |
| Trust taxable income | \$ 32,308 |
| Trust tax on capital gains | \$ 3,000 |
| Trust tax on ordinary income | |
| 35% × (\$80,000 - \$67,692) | <u>\$ 4,308</u> |
| Total tax paid by trust | \$ 7,308 Allocated to principal |
| Partnership distribution | \$ 75,000 |
| Trust tax liability | <u>(\$ 7,308)</u> |
| Payment to beneficiary | \$ 67,692 Allocated to income |