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The Evolution of the Principal and Income Act Under the EPTL

by Hon. C. Raymond Radigan

When the EPTL Advisory Committee was first formulated in 1990, one of our priorities was to review whether there ought to be a change in our law in order to accommodate the modern portfolio theory as it relates to investments and distributions. Although the matter is much more complicated, a simple example reflecting the problem would be a good starting point.

Background

In the 1970's when interest rates were high, many inexperienced non-corporate trustees invested in certificates of deposit and like investments, in order to take advantage of the high interest rates being paid on such accounts at that time. They were generally aware of the rule that a trustee, unless otherwise directed by the governing instrument, was to act impartially as to the income beneficiary and the remaindermen and they felt such investments would satisfy the rule. Assuming that the trust had assets of $1,000,000, with income to be paid to a beneficiary for life, remainder over to designated beneficiaries, it was their thinking that by investing in a certificate of deposit, they would be getting a good return for the income beneficiary, preserving the million dollars for the remainderman at the termination of the trust. This theory, of course, was flawed, because inflation diluted the value of the corpus, so that the million dollars was worth substantially less in real dollars at the termination of the trust. In addition, interest rates started to fall and income beneficiaries were no longer satisfied with the income that was being distributed to them.

The understanding of the modern portfolio theory started to unfold. Those disciplined in estate planning, estate taxation and armed with an understanding of the total return theory, started to educate their clients concerning how to invest trust assets in order to truly benefit both the income beneficiary and the remaindermen.

Many corporations and in particular, closely held corporations, were not declaring dividends or reduced them. Instead, they were taking their profits and reinvesting them back into their businesses in order to fuel growth. Thus, if the trust merely provided for income to the income beneficiary with no discretionary power to distribute corpus, and the assets were in equities or in low paying interest bank accounts, or bonds yielding the same result, the income beneficiary would suffer. Of course, those who were sophisticated would draft instruments to insure that the grantor's or testator's intent as to what should be distributed to an income beneficiary and what should be left for the remaindermen would be spelled out and not be subjected to default legislation. However when the instruments were not so specific, a trustee was left to the default legislation which provided for impartial treatment of the income beneficiary and the remaindermen, not freeing a trustee to invest for total return.

Modernizing Default Statute
In order to modernize our default statute in the State of New York concerning investment and distribution, the Advisory Committee (which I Chair) undertook an extensive study concerning the modern portfolio theory and consulted with many bar associations, bankers associations, investment counselors, estate planners, academics and others, and we were convinced that New York had to enact a new default legislation as it relates to prudent investment and equality in distributions.

The committee concluded that there were three specific reasons to justify change.

1. Economic conditions. It had become apparent that over the long term equities outperformed other forms of investment, although their dividend yields dropped significantly. Persistent inflation averaging at least three percent (and in double digits in the early 1980's) had eroded the purchasing power of the dollar. Many new investment vehicles such as mutual funds and derivatives had become popular.

2. Investment theory. The concept of total return investing without regard to the distinction between principal and income had become well recognized. Efficient market theory had identified the difficulty of outperforming the market because information affecting price was quickly available and taken into account. The value of diversification to minimize risk had been

established.

3. Tax and Trust law. Since 1962 when New York's last Principal and Income Act had become law, the gift and estate tax unified credit was created, as was the million dollar exemption from generation-skipping transfer tax, the QTIP elective marital deduction, the charitable remainder revisions, section 2702 annuity and unitrust rules, and the development of "Crummey powers" -- all of which encouraged new forms of tax saving trusts. Federal income tax rates for trusts and estates have been compressed so that for tax years beginning in 1998 ordinary income above $8,350 was taxed at the maximum rate. At the same time, top capital gains rates began to be greatly reduced. The law of fiduciary investment had moved from the "legal list" approach to the "Prudent Person Rule" in 1970 for each trust investment and then in 1995 to the "Prudent Investor Rule" for the entire trust portfolio.

The EPTL Advisory Committee recommended to the legislature, in its Third Report, that there be a new prudent investor act. EPTL 11-2.3 was enacted and made effective in 1995. It imposed a new default standard of trust investment, requiring a trustee to pursue an overall investment strategy, so as to enable the trustee to make appropriate present and future distributions to and for the benefit of all beneficiaries, under the governing instrument, in accordance with risk and return objectives reasonably suited to the entire portfolio.

Coupled with the adoption of the new prudent investor act was a 1997 proposal by the National Conference of Commissioners on Uniform State Laws to revise the Uniform Principal and Income Act, to replace the 1962 Uniform Act which New York primarily adopted under EPTL 11-2.1. These two events clarified the need for revision of the New York Principal and Income Act. It was clear that the new prudent investor act would not work unless there were also changes made to the New York Principal and Income Act.

The EPTL Advisory Committee initially analyzed the proposed 1997 Uniform Principal and Income Act. It represented a good deal of careful thought in many areas, particularly with respect to newer types of investment such as derivatives and newer understanding of other investments such as oil, gas and timber. The revised Uniform Act also clarified other matters such as apportionment at the beginning and end of an income interest. It was also noted that the revised Uniform Act contained many detailed rules to define trust accounting income. The Act recognized that its result may not produce a fair sharing of total return investing. For example, if a trust is entirely invested in equities, the income presumably will be too low a return to meet the needs of the current beneficiary. Section 104 of the revised Uniform Act gave trustees a limited power to adjust as between principal and income to achieve impartial treatment. Such power could enable trustees of existing trusts to invest for the total return, as encouraged by the New York Prudent Investor Act. (The Advisory Committee considered this adjustment power a consequence of the Prudent Investor Act, and recommended that it be placed in the Prudent Investor Act directly).

In its Fifth Report, the Advisory Committee recommended to the state legislature that Article 11 of the Estates Powers and Trust law be changed with respect to the definition of trust accounting income. The proposal was a major technical adjustment to existing law and represented a serious reformation of a critical aspect of the New York Law of Trusts concerning the definition of appropriate benefit currently distributable to a beneficiary.

The New Act: Total Return
Significant changes in economic conditions, investment theory, and tax and trust law forced New York to address the need to redefine principal and income for trust accounting purposes. As a result of our recommendations and the support of many other organizations, New York adopted a new principal and income act, EPTL 11-A-1.1, on Jan.1, 2002, to take into consideration the many changes that have taken place since 1962, as well as, to add a provision whereby a fiduciary can make adjustments between principal and income, so as to provide for equitable distributions of principal and/or retention of income, as the case may be.

In this way, the fiduciary is no longer conflicted between maximizing income for the benefit of the income beneficiary or seeking to grow the portfolio for the benefit of the remaindermen. Instead, unless the governing instruments provide otherwise, a trustee can invest for total return and be able to satisfy the needs of all beneficiaries. After investing the trustee can review whether the income received is adequate, excessive or insufficient, bearing in mind the distribution to the income beneficiary envisioned by the governing instrument. If adequate, then no adjustment need be made and all income would be distributed. If insufficient, then principal could be invaded in order to supplement the income available. If excessive, then income could be retained and added to principal. Accordingly, both the income beneficiary and the remaindermen would be equally protected under the total return theory.

The legislation, as enacted into law, preserves most of the traditional Principal and Income Act, as well as, the right of adjustment. The statute also provides for a right to elect to convert trusts into unitrusts. In addition, with recent favorable tax rulings, there is greater leeway to provide for total return without jeopardizing the marital deduction.

With the new Principal and Income Act, a fiduciary is now free to diversify assets and seek to maximize total return for the benefit of both income beneficiaries and remaindermen.

In the next article, I will discuss many of the proposed technical corrections to the new Principal and Income Act resulting from new federal tax regulations and experience with the Act since its enactment.

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