NYSBA

Staff Memorandum

EXECUTIVE COMMITTEE
Agenda Item #21

REQUESTED ACTION: Approval of an affirmative legislative proposal from the Trusts and Estates Law Section with respect to the calculation of trustee's commissions.

Attached is a report from the Trusts and Estates Law Section proposing an amendment to section 11-2.3(b)(5) of the Estates, Powers and Trusts Law (EPTL) to clarify the application of this section to the calculation of trustee's commissions. The report notes that the section empowers a trustee to make adjustments between principal and income if the trustee considers such adjustments advisable to enable the trustee to make present and future distributions that would be fair and reasonable to the beneficiaries. However, the trustee may not make an adjustment if the adjustment would benefit the trustee, either directly or indirectly. The report notes that many trustees apply the current statute inconsistently. The proposed amendment would clarify that , for purposes of calculating trustee's commissions, any adjustment of a trust asset from principal to income pursuant to the Prudent Investor Act – and vice versa – would effectuate a re-characterization of the transferred asset.

This report was published on the Reports Page in October 2011. No comments have been received.

The report will be presented at the January 26 meeting by Joseph T. De Ferlita, chair of the Section's Subcommittee on Effect of Power to Adjust on Trustee Commissions.

NOTICE

TO: Members of the Reports Group

FROM: Trusts and Estates Law Section of the New York State Bar Association ("TELS")

DATE: September 22, 2011

RE: Bill to Amend Section 11-2.3(b)(5) of the New York Estate Powers and Trusts Law

The Trusts and Estates Law Section of the New York State Bar Association is preparing a Report for approval by the New York State Bar Association in support of the passage and enactment of legislation amending Section 11-2.3(b)(5) of the New York Estates, Powers and Trusts Law ("EPTL") to clarify the application of said statute to the calculation of trustee's commissions for New York trusts. This Notice describes the subject matter of the Report (for an extensive discussion of the proposed legislation, see memorandum attached hereto as Exhibit A). For questions or comments about the Report, please contact Natalia Murphy, Chair of the Estate and Trust Administration Committee of the TELS, nmurphy@daypitney.com; and Joseph T. La Ferlita, Chair of the Subcommittee on Effect of Power to Adjust on Trustee Commissions of the Estate and Trust Administration Committee of the TELS, jlaferlita@farrellfritz.com.

Trustee's Power to Adjust. Section 11-2.3(b)(5) of the EPTL empowers a trustee to make adjustments between principal and income if the trustee considers such adjustment to be "advisable to enable the trustee to make appropriate present and future distributions" that would be "fair and reasonable to all of the beneficiaries...." Many trustees frequently decide to exercise the power to adjust to treat the income and principal beneficiaries fairly and in accordance with the statute. A trustee is prohibited from making such adjustment, however, where the adjustment

would benefit the trustee, either directly or indirectly.[1] An adjustment may incidentally result in an increase in the trustee's commissions, but the parenthetical language in the statute makes it clear that an incidental increase in the trustee's commissions resulting from the trustee's exercise of the power to adjust is not the type of indirect benefit that would violate the statute. Nevertheless, trusts and estates practitioners vary on the calculation of trustee's commissions where some re-characterize the trust assets for purposes of calculating commissions and some do not.

Thus, with regard to trusts that are not wholly charitable (i.e., private trusts), some individual trustees who exercise their power to adjust principal to income prefer to not re-characterize the transferred amount as income so as not to reduce the commission base for the calculation of commissions (which, for private trusts, are based on principal). However, many banks and trust companies serving as trustees choose to re-characterize such transferred amounts, thereby effectively reducing the commission base. Consequently, many trustees are applying the existing statute inconsistently and there is a considerable likelihood for trustee conflict when a trust is served concurrently by both an individual co-trustee and a corporate co-trustee.

The same question exists with regard to the commissions of a trustee of a wholly charitable trust (commissions are calculated based on the amount of income collected in a given year).[2] The question is whether, under EPTL § 11-2.3, the trustee would be entitled to compensation on the amount transferred from principal to income under the power to adjust, thereby increasing the base on which commissions are calculated.

Prudent Investor Act. The proposed amendment of the statute was evaluated in light of the definition and the basic purpose of the Prudent Investor Act, codified in New York as

[1] EPTL § 11-2.3(b)(5)(C)(vii) applies to trustees who are neither a current beneficiary nor a presumptive remainderman of the trust.
[2] SCPA 2309.

EPTL 11-2.3 (the "PIA"), as amended, as well as the Uniform Principal and Income Act, codified in Article 11-A of the EPTL (the "UPIA").

In 2001, New York adopted sweeping changes to the law of fiduciary investments by enacting new alternative ways of defining fiduciary accounting income and principal to better suit modern investment realities. The power to adjust, which applies to a trust that is subject to the UPIA, provides a trustee with the authority "to adjust between principal and income to the extent the trustee considers advisable to enable the trustee to make appropriate present and future distributions ... if the trustee determines ... that such adjustment would be fair and reasonable to all of the beneficiaries."[3]

The power to adjust is a necessary part of the total return investment regime because it ensures that a trustee has the flexibility to conform to the PIA. It "frees up the trustee to invest for the total portfolio, and then adjusts if the income flow is insufficient."[4] Accordingly, the adoption of the PIA and the UPIA contemplates that a trustee may now be obligated to invest the assets of a trust differently than he or she would have been obligated to do prior to the adoption of these laws. The power to adjust is a means of bridging the gap between the realities of total return investments with the interests of income and principal beneficiaries.

Consequently, any asset that is transferred pursuant to the PIA from the income account to the principal account, or vice-versa, should be deemed a re-characterization of the nature of such asset for purposes of calculating commissions. To do otherwise would be inconsistent with the total return investment regime of in the PIA and the UPIA.

Given the disparate treatment of trustee's commissions and the considerable potential for conflict among co-trustees, and in light of the principles underlying the PIA and the

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[3] EPTL 11-2.3(b)(5)(A).
[4] Turano, McKinney's Laws of New York, EPTL Article 11, 2008 Practice Commentaries.

UPIA, EPTL § 11-2.3 should be amended to clarify that, for purposes of the calculation of trustee's commissions, any adjustment of a trust asset from the principal account to the income account pursuant to the PIA effectuates a re-characterization of such transferred asset as an item of income. In addition, any adjustment of a trust asset from the income account to the principal account pursuant to the PIA would effectuate a re-characterization of such transferred asset as an item of principal.

Exhibit A

MEMORANDUM

TO: Executive Committee

FROM: Subcommittee on Effect of Power to Adjust on Trustee Commissions:
Jill Choate Beier
Joseph T. La Ferlita

DATE: March 26, 2011

PROPOSED AMENDMENT TO SECTION 11-2.3(b)(5) OF NEW YORK'S ESTATE POWERS AND TRUSTS LAW

I. INTRODUCTION

In this low-interest rate environment, trustees often find themselves utilizing the power to adjust set forth in Section 11-2.3(b)(5) of the New York Estates, Powers and Trusts Law (the "EPTL") to adjust between the principal and income of a trust to ensure that the income beneficiaries receive timely and appropriate distributions of income. As a result, many trustees must face the issue regarding the calculation of commissions for trusts where he or she has exercised the authority to make adjustments from principal to income. Many practitioners and trustees believe that the statute does not clearly address the commission calculation issue where a trustee utilizes the power to adjust.

II. OVERVIEW OF THE PROBLEM

Section 11-2.3(b)(5) of the EPTL empowers a trustee to make adjustments between principal and income if the trustee considers such adjustment to be "advisable to enable the trustee to make appropriate present and future distributions" that would be "fair and reasonable to all of the beneficiaries...." However, a trustee is prohibited from making such

adjustments in several circumstances.[5] One such circumstance is where the adjustment would benefit the trustee, either directly or indirectly.[6] Many trustees frequently decide to exercise the power to adjust to treat the beneficiaries fairly and in accordance with the statute. Such adjustments often incidentally result in an increase in trustee's commissions. This situation raises the question of whether such an adjustment violates clause (b)(5)(c)(viii) of Section 11-2.3 because the increase in the trustee's commission is a prohibited indirect benefit to the trustee within the meaning of the statute.

The amendments to the statute in 2008 clarified this issue by adding the parenthetical phrase "(which, however, shall not include the possible effect on a trustee's commission)."[7] The parenthetical language makes it clear that an incidental increase in the trustee's commission resulting from a trustee's exercise of the power to adjust is not the type of indirect benefit that would violate the statute. Indeed, the Practice Commentaries of McKinney's Laws of New York, written by Professor Margaret Valentine Turano ("Turano"), discusses whether the increase in trustees' commissions is a prohibited indirect benefit to the trustee and concludes that the 2008 amendments to the statute clarify this issue.[8]

Richard Nenno ("Nenno")[9] points out, however, that a question regarding the calculation of trustee's commissions arises where such commissions are based on the trust's income. Nenno concludes that it is unclear whether the trustee should be compensated on amounts adjusted from principal to income (e.g., whether the amount adjusted should be re-characterized for purposes of calculating commissions) notwithstanding the fact that some state

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[5] *See* EPTL § 11-2.3(b)(5)(C).
[6] EPTL § 11-2.3(b)(5)(C)(vii) applies to trustees who are neither a current beneficiary nor a presumptive remainderman of the trust.
[7] *Id.*
[8] Margaret V. Turano, McKinney's Laws of New York, EPTL Article 11, 2008 Practice Commentaries.
[9] Richard Nenno, *The Power to Adjust and Total-Return Unitrust Statutes: State Developments and Tax Considerations*, 42 REAL PROP. PROB. & TR. J. 657 (2008).

statutes permit the trustee to be compensated on such adjusted amounts. In New York, for example, the commissions for a trustee of a wholly charitable trust are calculated based on the amount of income collected in a given year.[10] Under EPTL § 11-2.3, the trustee would be entitled to compensation on such income even where the trustee exercised the power to adjust and transferred an amount from principal to income, thereby increasing the base on which commissions are calculated. Nenno's questioning of whether amounts adjusted from principal to income should be re-characterized for purposes of calculating trustees' commission highlights the need for clarification, particularly in the case of wholly charitable trusts.

Other types of situations also present the need for clarification. For example, where an individual trustee of a private trust exercises his or her power to adjust principal to income, such trustee may prefer to continue to characterize the transferred amount as principal for purposes of the paying out and annual commission calculations. On the other hand, many banks and trust companies do not include such transferred amounts in the calculation of annual commissions. Consequently, there is the potential for conflict between an individual and a bank or trust company who are acting as co-trustees of a trust regarding the calculation of trustees' commissions.

III. PROPOSED SOLUTION

In light of the above, the Subcommittee concluded that a statutory amendment is needed. However, the problem cannot be addressed in a vacuum, but rather must be considered in light of (i) the basic purpose of the Prudent Investor Act, codified in New York at EPTL 11-2.3 (the "PIA"), as amended, as well as of the Uniform Principal and Income Act, codified in Article 11-A of the EPTL (the "UPIA"), (ii) the definitional section of the UPIA codified at EPTL 11-A-1.2 and (iii) the technical corrections that were made to the PIA in 2008.

[10] SCPA 2309.

In so doing, the Subcommittee concludes that, for purposes of the calculation of a trustee's commission, any adjustment of a trust asset from the trust's principal account to the trust's income account (or vice-versa) pursuant to the PIA effectuates a re-characterization of such transferred asset as an item of income (or principal, as the case may be). The failure to re-characterize the transferred asset would be inconsistent with the PIA and the UPIA.

A. THE POWER TO ADJUST AND THE UNIFORM PRINCIPAL AND INCOME ACT.

a. Background.

Prior to the adoption of the PIA and the UPIA, the trustee of an irrevocable trust that mandated the distribution of fiduciary accounting income but did not authorize the trustee to distribute principal to the current beneficiary faced a conflict of interest between the current and remainder beneficiaries. The conflict was rooted in the fact that, often, assets that produce generous income suffer from meager growth or heightened risk, whereas assets that are likely to appreciate generate little or no income.[11] Thus, investing for maximum yield often came at the price of inhibited trust growth and increased risk, while investing for maximum growth often came at the price of meager income.[12] Compounding the problem was the fact the interest generated by fixed income assets continued to decrease over the years.[13] This conflict placed the trustee in a difficult situation because of the fiduciary obligation owed to each of the current and remainder beneficiaries.

In 1994, New York adopted the PIA, which transformed the standard by which trust investments were to be judged. Prior to the PIA, trustees' performance was judged by

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[11] See *Supplement to the Fifth Report of the EPTL-SCPA Legislative Advisory Committee* 2-3 (May 26, 2000).
[12] *See New York Estate Administration*, § 14.06, by Margaret V. Turano & C. Raymond Radigan (LexisNexis 2009).
[13] *See* Nenno, 42 REAL PROP. PROB. & TR, J., p. 657.

considering the prudence of each individual investment[14]. Under the PIA, however, a trustee is required "[t]o pursue an overall investment strategy to enable the trustee to make appropriate present and future distributions to or for the benefit of the beneficiaries under the governing instrument, in accordance with risk and return objectives reasonably suited to the entire portfolio"[15]. The PIA embodies what is commonly referred to as a "total return" investment philosophy.

While the PIA articulated the new standard by which a trustee was to be held, it did not go far enough in providing the tools to implement it. The definitions of fiduciary accounting income and principal were too restrictive.[16] Many trustees investing for total return saw terrific growth of principal coupled with ever decreasing income levels, but were unable to shift some of the benefits of the growth to the current beneficiary.

In response, in 2001, New York adopted sweeping changes to the law of fiduciary investments by enacting two new alternative ways of defining fiduciary accounting income and principal: (a) the UPIA (which includes the power to make adjustments between income and principal codified within the PIA at EPTL 11-2.3(b)(5)), and (b) the unitrust option, under which fiduciary accounting income generally is defined simply as four percent of the trust's value each year irrespective of the trust's actual income.

The UPIA redefined the definitions of fiduciary accounting income and principal to better suit modern realities. The power to adjust, which applies to a trust that is subject to the UPIA (and thus not the unitrust provisions of EPTL Section 11-2.4), provides a trustee with the authority "to adjust between principal and income to the extent the trustee considers advisable to

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[14] *See* Turano & Radigan § 14.06.
[15] EPTL 11-2.3(b)(3).
[16] *See Supplement to the Fifth Report of the EPTL-SCPA Legislative Advisory Committee* 2 (May 26, 2000).

enable the trustee to make appropriate present and future distributions ...if the trustee determines ... that such adjustment would be fair and reasonable to all of the beneficiaries."[17].

The power to adjust is a necessary part of the total return investment regime because it ensures that a trustee has the flexibility to conform to the PIA. It "frees up the trustee to invest for the total portfolio, and then adjusts if the income flow is insufficient"[18]. Thus, it can be viewed as a trustee's "back-up tool" in the event that the new definitions of fiduciary accounting income and principal as set forth in the UPIA fail to enable the trustee to fulfill his or her fiduciary obligations to both the current and remainder beneficiaries. For example, if in a given year the trust's assets appreciated significantly but produced insufficient income, the trustee can transfer an appropriate amount of the trust principal to income and then make a distribution of income to the current beneficiary. Conversely, if in a given year the trust's assets generated a tremendous amount of fiduciary accounting income but appreciated little, or even depreciated, the trustee can transfer a portion of such income to principal. The point is that, unitrusts aside, the power to adjust ensures that the total return investment strategy can be implemented, and frees the trustee from the archaic, limited definitions of income and principal.

b. Approaching the Commission Statutes in a Manner Consistent with the PIA and the UPIA.

The instant problem requires one to reconcile the commission statutes (e.g., Surrogate's Court Procedure Act ("SCPA") Section 2309), which were enacted decades ago at a time when the definitions of income and principal were rigid, to the relatively recently-adopted laws of the PIA and the UPIA, the latter of which have introduced more fluid concepts of principal and income.

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[17] EPTL 11-2.3(b)(5)(A).
[18] Turano, McKinney's Laws of New York, EPTL Article 11, 2008 Practice Commentaries.

The effect of the adoption of the PIA and the UPIA is that a trustee may now be obligated to invest the assets of a trust differently than he or she would have been obligated to do prior to the adoption of these laws. For example, the emphasis on total return might require a trustee to invest in assets that produce less income but exhibit greater growth potential than other assets in which the trustee would have invested had the emphasis not been on total return. As discussed above, the interests of the current beneficiary are not lost under the PIA and the UPIA. Rather, the UPIA's revised definitions of income and principal, as well as the PIA's power to adjust, afford the trustee the ability to allocate the appropriate share of the investment returns to the current beneficiary.

The power to adjust is a means of bridging the gap between the realities of total return investments with the interests of the current beneficiary and the remaindermen. Accordingly, any assets that are transferred pursuant to the PIA from the income account to the principal account, or vice-versa, should be deemed a re-characterization of the nature of such asset for purposes of calculating commissions. When calculating commissions, therefore, the relevant commission base should be analyzed after the adjustments are made, and not before. To do otherwise would be inconsistent with the total return investment regime inherent in the PIA and the UPIA.

B. THE DEFINITIONAL SECTION OF THE UPIA.

The definitional section of the UPIA provides support for the Subcommittee's conclusion.

The UPIA defines "income beneficiary" at EPTL 11-A-1.2(5) as "a person to whom net income of a trust is or may be payable." "Net income," in turn, is defined at EPTL 11-A-1.2 (8) as "the total receipts allocated to income during an accounting period minus the

disbursements made from income during the period, plus or minus transfers under [Article 11-A of the EPTL] or under subparagraph 11-2.3(b)(5) to or from income during the period" (emphasis added).

For example, if a trustee were to exercise the power to make an adjustment from principal to income, the transferred amount is re-characterized; i.e., what began as principal is transformed into income such that an income beneficiary becomes entitled to receive it. Thus, the notion of re-characterization is consistent with the definition of net income.

C. THE 2008 TECHNICAL CORRECTIONS TO THE PIA.

a. Background.

From the time it was enacted, the PIA contained multiple safeguards aimed at preventing abuse of the power to adjust.[19] One of the original safeguards prevented a trustee from making adjustments "if the trustee is not a current beneficiary or a presumptive remainderman, but the adjustment would benefit the trustee directly or indirectly ...."

However, this particular safeguard presented a problem to many trustees. According to the memorandum of the EPTL-SCPA Legislative Advisory Committee (the "Advisory Committee") in support of the technical corrections of the PIA:

> The banking community has expressed deep concern that this provision could be interpreted as denying the adjustment power because of an adjustment's incidental effect on computation of the trustee's commissions. Thus, e.g., an adjustment from income to principal would increase the amount of principal on hand on which annual commissions will be based and which may eventually qualify for a 1% termination commission. The provision was in no way intended to cover such a miniscule side effect of a trustee act having such high independent significance as its achievement of a proper overall investment strategy through the use of the adjustment power. The law has never required that the trustee's power and duty to adopt investment policy be exercised only in a

[19] *See* EPTL 11-2.3(b)(5)(C).

> manner that would have no incidental effect on its commission. In clear cases of significant benefit to a trustee, EPTL 10-10.1 will prevent the exercise of allocation discretion if there is no independent co-trustee to do it. An in any event, under general equitable principles, it should sill be expected and permitted that trustee acts can be tested by the apparent balance between their independent significance, benefits to the trust, and benefits flowing directly or indirectly to the trustee.[20]

Upon the Advisory Committee's recommendation, New York State in 2008 amended the PIA such that, inter alia, it became clear that the prohibited benefits of the exercise of the power to adjust do not include increases to trustees' commissions as a result of such exercise. The statute now states that "[a] trustee may not make an adjustment ... if the adjustment would benefit the trustee directly or indirectly (which, however, shall not include the possible effect on a trustee's commission) ...."[21]

b. The Reasonable Implication of the Advisory Committee's Memorandum in Support of the 2008 Technical Corrections Is that an Adjustment Effectuates a Re-Characterization.

One could argue that the phrase "which, however, shall not include the possible effect on a trustee's commission" would not have been necessary if the legislature concluded that an adjustment would not effectuate a re-characterization. Others could argue that the word "possible" indicates the legislature's silence on this issue; it did not decide the matter, but wanted to make clear that, to the extent the matter is decided in favor of re-characterization, the effect of such re-characterization on commissions would not be deemed a prohibited benefit.

The Subcommittee concludes that any doubts about this issue are resolved by the Advisory Committee's above-referenced memorandum. Implicit in the Advisory Committee's

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[20] EPTL-SCPA Legislative Advisory Committee Memorandum dated March 22, 2007, at pp. 6-7 (emphasis added).
[21] EPTL 11-2.3(b)(5)(C)(vii) (emphasis added).

comments, emphasized above, is the assumption that an adjustment pursuant to the PIA effectuates a re-characterization. The example given by the Advisory Committee involves an adjustment from income to principal. This adjustment would result in a benefit to the trustee in that such transferred amount might eventually qualify for the one percent paying-out commission. That qualification could be possible only to the extent that character of the transferred amount is transformed from income to principal for purposes of the commission statutes. It should be noted, however, that, at the Executive Committee's suggestion, the Subcommittee reached out to Linda Hirschson, Esq., who is a member of the Advisory Committee. She explained that the Advisory Committee had not explicitly considered the effect of an adjustment on trustee commissions when it prepared its Memorandum in Support of the 2008 Technical Corrections.

D. PROPOSED AMENDMENT.

In light of the foregoing, the Subcommittee recommends amending EPTL 11-2.3 by adding a new clause (G) in subparagraph (5) of paragraph (b) of the statute, which states:

> Any exercise of the power to adjust under this subparagraph, whether from income to principal or from principal to income, shall constitute a re-characterization of the transferred amount from income to principal or from principal to income, as the case may be, for purposes of calculating commissions under article 23 of the surrogate's court procedure act.

IV. CONCLUSION

For the forgoing reasons, the Subcommittee concludes that, for purposes of the calculation of a trustee's commission, any adjustment of a trust asset from the trust's principal account to the trust's income account, or vice-versa, pursuant to the PIA effectuates a re-characterization of such transferred asset as an item of income or principal, as the case may be.