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The Marital Unitrust

***480** THE MARITAL UNITRUST: A NEW PLANNING STRATEGY FOR THE REMARRIED SPOUSE

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A typical case

Michael, who recently married for the second time, has wisely arranged a meeting with his estate planning attorney to discuss provisions for his new wife and three children from a prior marriage. At the meeting, the estate planner suggests that Michael use a QTIP marital trust, which will provide for all income to be distributed to his wife for the rest of her life with the remainder passing, upon her death, to his children.

In response to this suggestion, Michael inquires as to what constitutes 'income.' The attorney clarifies that income includes items like interest and dividends. Michael, who is a shrewd investor with the bulk of his assets in marketable securities, wonders whether this 'income' amount also includes capital appreciation. The attorney's answer is 'no.' Michael, a bit perplexed, questions how his assets will continue to grow for the benefit of his children while at the same time being used to provide income for the support of his wife.

The attorney explains that it is usually not possible to promote much capital appreciation in the QTIP context because investments must be structured to consider the needs of both the remainder beneficiaries and the income beneficiary. Therefore, some portion of the trust must be invested to generate current income for the surviving spouse. The attorney assures Michael that some fraction of the trust portfolio may be invested for growth. The prospect of this future income-oriented portfolio disturbs Michael's sense of proper investment diversification. Is Michael out of luck? Perhaps not. There is a way to accomplish both goals of taking care of the surviving spouse and promoting overall growth of principal--the Marital UniTrust ('MUT').

Introduction

Planning for the surviving spouse (particularly in the case of a remarriage with adult children from a prior marriage) can be one of the most difficult jobs for an estate planner. Balancing the needs of the surviving spouse with the interests of the lineal descendants is not an exact science. Indeed, many times it is more like a mine field. Litigation in this context (again, particularly in the case of the remarried spouse) is frequent and usually difficult to settle.

To a large degree, the litigation results from the trust planning we advisors create. As discussed below, traditional estate planning tends to pit the surviving spouse against the lineal descendants in every decision about choosing an investment or making a distribution of principal. With such great tension, it is no wonder litigation results. However, if planners ***481** change their approach and present clients with another choice (the Marital UniTrust--'MUT'), then perhaps more clients will elect to align the interests of the surviving spouse and those of the lineal descendants.

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In planning for surviving spouses of second or subsequent marriages (while taking into account the needs of children from prior marriages), the MUT may be an ideal tool. Thus, while the MUT should be considered appropriate for all married clients, this article focuses on its particular application to remarried clients.

The MUT is a total return unitrust designed to qualify for the marital deduction under Section 2056. A typical MUT provides for the decedent's spouse to receive a unitrust payment equivalent to some percentage of the total value of the trust as of a given date (or all of the trust income, if greater) on at least an annual basis.

MUTs alleviate some of the pressures and constraints facing trustees by relieving the inherent friction between the income beneficiary and the remainder beneficiaries. Moreover, the MUT reflects a new understanding of marital trust management and investment concepts that have evolved from historic notions of 'income-only' investments to modern portfolio theories promoting total return investments. Overall, MUTs achieve decedents' goals of providing for their spouses and children, promoting aggressive portfolio growth, and obtaining the tax advantages of QTIP.

MUTs should also be considered in the context of prenuptial agreements. When advising clients about post-death options for prenuptial agreements, the MUT should be examined carefully. Because the MUT places the surviving spouse and descendants 'on the same side of the table,' it tends to foster harmony. Consequently, a MUT might be the perfect element to assuage clients in negotiating prenuptial agreements.

Current 'QTIP' approach

Since 1981, the typical planning arrangement for a second or subsequent marriage primarily involves the use of a traditional QTIP trust--in which the spouse receives all the income for life and may receive distributions of principal (usually under defined standards), although many clients prefer not to permit principal invasions. The remainder of the QTIP trust passes to the decedent's children from the prior marriage. [FN1] This income-only arrangement has always been inherently flawed. There is an obvious conflict of interest between the stepparent/income beneficiary, who wants to maximize the income interest at all costs, and the children/remainder beneficiaries, who would prefer to see the trust assets appreciate regardless of the effect on current income.

Principal invasion can also cause great friction. Before making distributions of principal, trustees frequently must consider the surviving spouse's needs and her ability to meet such needs from other sources of income. Naturally, the remainder beneficiaries will believe the trustee should be less liberal with principal invasions. 'A marital trust in a second marriage situation gives rise to pressures that are not often present in the traditional marriage. Children who would endorse a principal disbursement or a heavily weighted bond portfolio if their surviving parent were the income beneficiary, will view matters differently if a step-parent is the income beneficiary. ' [FN2] However, even in first marriage situations where the children of that marriage are the remainder beneficiaries, those children may be quite uncomfortable with principal invasions for their surviving parent, especially if the surviving parent has remarried.

Further, the traditional type of restrictive QTIP arrangement creates a volatile situation likely to induce litigation by one or both of the parties against each other and/or against the trustee. Because this situation is ripe for litigation, the choice of trustee becomes quite complicated. Naming the spouse or child(ren) as trustee will inevitably create more tension, jeopardizing the trustee's managerial and fiduciary duties.

If the spouse is appointed trustee, her incentive will be to weight investments heavily toward income and to use principal liberally when needed. If the child is nominated as trustee, the child's incentive typically will be to weight the portfolio for growth, and the child most likely will be reluctant to invade principal. Consequently, the surviving spouse may need to rely on state under-productive property statutes and Section 2056 of the Code to demand at least a minimum standard of living. Alternatively, *482 appointing an independent trustee might alleviate some of the litigation, but how should that trustee be guided in managing the trust fund? Unless the client clearly articulates standards for the trustee, even an independent trustee is likely to be caught between the 'friendly fire' of the surviving spouse and the children.

Finally, the overall trust investment objectives (in a traditional QTIP trust) are not in line with modern realities of investing in today's markets. The income-only approach does not facilitate achieving the long-term investment goals

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of the trust. These obvious problems have been recognized in the industry and have spurred the development of modern portfolio theory (the 'Prudent Investor Rule') and total return trusts.

Modern portfolio theory/total return investing

One major reform in the industry has been the changing perspective on investment theory. 'Traditional trust accounting income as the measure of current benefit from a trust is arbitrary, manipulable and contrary to modern investment understanding.' [FN3] As a result, 'modern portfolio theory has been gaining acceptance as the foundation of trust investment law.' [FN4] Modern portfolio theory is based predominantly on the concept that an asset's value is a function of the following two factors: (1) the rate of total return (ordinary income plus capital appreciation) that the asset is expected to generate, and (2) the risk that the actual return will fall short of the expected return. [FN5] Analysis of the second factor indicates an emphasis on viewing assets as integral parts of the whole portfolio rather than as investments existing independently in isolation, which in turn further enhances the importance of focusing on a total rate of return. [FN6]

The three sources that have brought this theory of total return investing into the mainstream of fiduciary law are the Restatement of Trusts (Third), the Uniform Prudent Investor Act (1994), and the Uniform Principal and Income Act of 1997 (the '1997 Act'). [FN7] A central purpose of the 1997 Act 'is to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of 'income' as traditionally perceived in terms of interest, dividends and rents.' [FN8] The Prudent Investor Act adopted in New York (effective in 1995) requires a trustee 'to 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.' [FN9]

The primary trust structure for promoting these new ideals and attaining the goal of maximum total investment return is the total return unitrust. In a number of commentaries, the total return unitrust has been touted as a new ideal for trust planning. [FN10]

Marital UniTrusts ('MUTs')

A total return unitrust directs the trustee to pay to the current beneficiary a specific percentage (as defined by the testator) of the total value of the trust as determined at least annually. This type of arrangement facilitates total return investing and promotes harmony among current and remainder beneficiaries. It also allows a trustee to better fulfill the duty of impartiality.

The positive benefits of adopting total return trusts are perhaps most relevant in connection with ***483** estate planning for the remarried spouse. The total return unitrust can easily be structured to qualify for the marital deduction (i.e., QTIP election) by providing that the spouse will receive the greater of the unitrust amount or trust accounting income. [FN11] Using MUTs should provide tremendous advantages to all parties in terms of planning, management, administration, and satisfaction. [FN12]

Use of the MUT harmonizes the interests of the spouse/income beneficiary and the children/remainder beneficiaries. Both should find it easier to understand and accept the total return investment philosophy, which seeks to maximize the return for both interests. [FN13] The spouse will have reasonable expectations for current and future distributions, thus allowing her to engage in more effective financial planning. [FN14] Because the spouse and children share a common investment goal (e.g., to maximize total return), the trustee and investment advisors can be more focused on developing an overall investment strategy. Investment decisions can be more naturally based on the relative needs and risk tolerances of all beneficiaries. [FN15]

In addition, the MUT should decrease the likelihood of litigation by the spouse against the trustee for investing too heavily for long-term growth, and similarly by the children against the trustee for investing too much in income-producing assets. Moreover, reliance on principal distributions should be eliminated (or significantly reduced), alleviating litigation on that front as well. In essence, by providing for the current needs of the spouse plus the growth-oriented hopes of the children without sacrificing investment return, it is hoped that a degree of impartiality

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and harmony can be obtained.

The MUT can greatly reduce the effects of market fluctuations and adverse conditions as well as create tax-advantageous ways of distributing current income. For example, by 'pruning' equity investments (i.e., judiciously selling amounts of stock from principal to meet the distribution payouts required by the trust), a greater amount of each payment to the spouse will consist of nontaxable return of basis and/or capital gains as opposed to ordinary income. [FN16]

This technique reduces the spouse's tax liability and thus increases the spouse's after-tax income available for her support. Hence, the spouse is less likely to need additional distributions, allowing the trustee to preserve principal for the children/remainder beneficiaries. Because the MUT is not invested exclusively in fixed income or bond portfolios, the MUT can also minimize the impact of interest rate fluctuations.

Unfortunately, the income tax consequences of MUTs are not yet completely settled. With a MUT, the annual taxable income will usually be less than the unitrust ***484** payment. Nevertheless, due to increased portfolio turnover and stock market investments in general, the annual capital gains in the trust might be significant. Capital gains are usually not part of a trust's distributable net income ('DNI'). Code Section 643 and the accompanying Regulations provide that capital gains are included in DNI only under limited circumstances.

A MUT may be drafted with a direction that the annual unitrust payment be satisfied (1) first from ordinary income, (2) then from short-term capital gains, (3) then from long-term capital gains, and (4) finally from principal. However, it is presently unclear if the IRS would recognize and implement such an ordering of the distributions. If so, then the spouse is still better off, because part of the annual distribution may be taxed as long-term capital gains and/or may be received tax-free as principal. On the other hand, if capital gains are not included in DNI at all, then the distribution to the spouse might be virtually tax-free--in which case the payout rate may need to be revisited. At this time, there is no concrete answer, but we have been told that at least one (and perhaps more than one) request has been presented to the IRS to address this issue.

Similarly, use of a 'smoothing provision' (described below) in the MUT can dramatically reduce the impact of changing market conditions and consequent volatility in payout amounts to the spouse. [FN17] In addition, planners can draft MUTs to include some discretionary payments to the spouse; however, the circumstances under which such distributions will be made should be significantly reduced--and the MUT may say so. [FN18]

Choosing a payout amount

One of the most important factors in establishing a MUT for a remarried individual is to choose the proper percentage payout amount. 'There is probably no infallible projection as to a unitrust rate that will preserve principal purchasing power of principal and also provide a reasonable current benefit. ' [FN19] The performance of any trust will be determined by particular investments, market performance, and general economic conditions. Fortunately, there is some guidance in the industry. Based on historical experience, some experts agree that if the trust is reasonably invested for total return, a 4% unitrust rate will tend to preserve the purchasing power of both the current distribution and the remainder. [FN20] The submission by the New York State EPTL-SCPA Advisory Committee to the New York legislature of its version of the new Uniform Principal and Income Act contained a 4% unitrust rate as the statutory return for the life of the income beneficiary. [FN21]

Aside from the apparent industry recommendation, there are additional factors to consider in choosing the proper unitrust rate. 'A unitrust rate designed to preserve the purchasing power of both the trust principal and the annual withdrawal would need to be at a rate of expected total return reduced by an expected inflation rate.' [FN22] If proper assumptions are made regarding expected total return and inflation, then increasing or decreasing the unitrust rate (above or below 4%) could greatly affect the relationship between the income and remainder interests. In this regard, careful consideration should be given to the relative needs of the spouse and children. For example, in the case of a smaller trust where the spouse's needs take precedence, an increased unitrust rate might be appropriate, despite the potential for damaging the value of the children's remainder interest. [FN23] Similarly, if the spouse will have adequate other means of support, a smaller unitrust rate could be used to substantially increase the remainder interest while reducing the total value of withdrawals over time.

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To promote a significant reduction in the volatility of the payout amount from year to year (due, for example, to changing market conditions), the planner can use a unitrust rate in conjunction with a 'smoothing provision.' [FN24] Under this scenario, the annual payout to the spouse would be based each year on the unitrust percentage rate multiplied by the average of the trust values for a specific number of previous years. For example, a MUT could provide that the annual payout is determined by multiplying the distribution rate by the average of the values of the trust on the last day of the three preceding ***485** years. This back-averaging method is known as 'smoothing,' and use of such a three-year smoothing provision can decrease distribution volatility by up to 50%. [FN25]

Designing a proper unitrust rate can also accomplish tax planning. When a MUT is used in connection with a credit shelter or bypass trust, the unitrust rate can be structured to funnel benefits away from the IRS and ultimately into the hands of the children. [FN26] Specifically, by setting a higher marital unitrust rate and a relatively low payout from the credit shelter trust (or only discretionary payouts after the MUT is exhausted), the amount subject to estate tax in the MUT should be greatly diminished while the tax-free growth of principal of the credit shelter trust should be significantly enhanced. [FN27] Additional distributions can be made to the spouse (if needed) from the principal of the MUT, thereby further reducing its tax liability upon the surviving spouse's death. [FN28] Overall, more assets should pass to the remainder beneficiaries.

Conclusion

The MUT should be considered as a new model for second marriage estate planning. The MUT solves many of the problems associated with use of traditional QTIP marital trusts and effectively balances the interests of the decendent's spouse and children. Based on the industry commentary, investing for total return is now the standard regime, and nowhere is this more relevant than in the area of marital trust planning.

The trustee can invest to maximize both the income and remainder interests and uphold the duty of impartiality with respect to all beneficiaries. The spouse and children are essentially placed on the same page, sharing a common goal of increasing the total value of the MUT principal. Litigation between the parties and trustee over investment decisions can be significantly reduced (and maybe eliminated). Further, the decedent has flexibility to structure the MUT in an appropriate fashion, by choosing the percentage payout amount and perhaps a smoothing mechanism. As Michael's estate planning attorney can now tell him, the MUT is a good alternative arrangement for his second marriage estate planning.

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[FN1]. See Kiziah, 'Drafting Wills for the Remarried Spouse,' 71-JAN Fla. B.J. 34 (Jan 1997); Bloom, 'Making Hay While the Sun Shines: Non-Charitable Estate Planning Techniques,' 285 PLI/Est 25 (Nov 1999); Harrison, 'Defensive Strategies for Potential Will and Trust Contests,' 13-DEC Prob. & Prop. 6 (Nov/Dec 1999).

[FN2]. See Kiziah, supra note 1, at 34.

[FN3]. Sherwood, 'Tax Aspects of Using a Unitrust Amount to Define Appropriate Benefit Currently Distributable From Non-Charitable Trusts,' 70-OCT N.Y. St. B.J. 70 (Sept/Oct 1998).

[FN4]. Keister and McCarthy, '1997 Principal and Income Act Reflects Modern Trust Investing,' 26 ETPL 99, 104 (Mar/Apr 1999).

[FN5]. Horn, 'Drafting of Dispositive Provisions Under Prudent Investor Rule,' SD85 ALI-ABA 135, 170 (6/13/99).

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[FN6]. Id.

[FN7]. Edwards and Spencer, 'Trusts for the New Century: The Third Paradigm,' www.leimberg.com/tapes/edwards.html at 9 (1999).

[FN8]. Id. A means for achieving this goal is provided in section 104 of the 1997 Act. This section authorizes a trustee to adjust between income and principal (in case the income portion of the trust's total return is too small or too large) in an effort to properly administer the trust impartially for the benefit of all beneficiaries, thus allowing the trustee to make the best investment decisions in line with the Prudent Investor Rule set forth in the Uniform Prudent Investor Act. Spencer and Clark, 'Total Return Trusts: Trusts in the New Millennium,' www. leimberg.com/tapes/spencer.html at 8 (1999). Section 104 of the 1997 Act states: 'If a trustee who invests and manages trust assets as a prudent investor determines that the trust instrument does not contain discretionary powers of administration that are sufficient to permit the trustee to comply with the duty to pay due regard to the interests of income and remainder beneficiaries, the trustee may adjust between principal and income to the extent the trustee considers it necessary to administer the trust impartially based on what is fair and reasonable to all of the beneficiaries or to administer the trust to achieve the settlor's intent if the terms of the trust clearly manifest an intention that the trustee shall or may favor one or more of the beneficiaries.' In the case of a QTIP marital trust, however, the trustee could not make adjustment(s) pursuant to this power if such adjustment(s) would diminish the income interest of the spouse. Moreover, a trustee who is also a beneficiary of the trust cannot exercise this power to adjust.

[FN9]. See Sherwood, supra note 3, at 70.

[FN10]. See Sherwood, supra note 3; Kiziah, supra note 1; Keister, supra note 4; Horn, supra note 5; and Edwards, supra note 7.

[FN11]. The New York EPTL-SCPA Advisory Committee to the New York State legislature plans to request an IRS ruling that a percentage designation of income constitutes 'income' for purposes of meeting marital deduction requirements. See Hilker, 'ALI-ABA Course of Study: Annual Spring Estate Planning Practice Update,' Q281 ALI-ABA 11, 15 (5/13/99). In the meantime, the 'greater of income . . .' provision will suffice.

[FN12]. See Edwards, supra note 7 at 3; Wolf, 'Defeating the Duty to Disappoint Equally--the Total Return Trust,' 32 Real Prop. Prob. & Tr. J. 45 (Spring 1997); Hoisington, 'Modern Trust Design: New Paradigms for the 21st Century,' 31 U. Miami Heckerling Inst. on Est. Plan. (1997); Sherwood, supra note 3, at 70.

[FN13]. See Edwards, supra note 7, at 3.

[FN14]. See Sherwood, supra note 3, at 70.

[FN15]. See Edwards, supra note 7, at 4.

[FN16]. Id.; see also Wolf, supra note 12, at 85.

[FN17]. Id.

[FN18]. The MUT may provide something like: 'While I have granted Trustee discretionary authority to distribute additional amounts to my Spouse, Trustee should be guided by my preference that the annual distribution (the unitrust payment) ought to be sufficient to support my spouse. As such, I direct Trustee to make additional distributions only when such are absolutely essential and cannot be satisfied from other sources.'

[FN19]. See Sherwood, supra note 3, at 71.

[FN20]. Id.; see also Wolf, supra note 12.

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[FN21]. See Hilker, supra note 11, at 15.

[FN22]. See Sherwood, supra note 3, at 71.

[FN23]. Id.

[FN24]. See Edwards, supra note 7, at 4.

[FN25]. Leimberg, 'The Total Return Trust (TRU) Revolution: An Introduction,' 34 U. Miami Heckerling Inst. on Est. Plan. (2000), Special Session I-C Report, p. 4.

[FN26]. Id.

[FN27]. Id.

[FN28]. Id.

27 Est. Plan. 480, 2000 WL 1721583 (W.G.&.L.)

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