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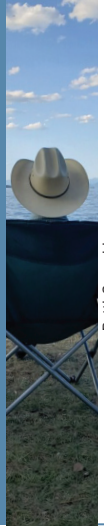
MontGuide



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FAMILY FINANCIAL MANAGEMENT

MT202113HR, CURRENT AS OF 12/21

Testamentary Trusts in Montana

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What is a testamentary trust?

A **testamentary trust** allows a **trustee** to manage assets on behalf of a beneficiary. A **settlor** is a person who creates a testamentary trust. The terms of the trust are set forth in the settlor's written Will. A testamentary trust does not legally exist until the settlor dies and the Will of the settlor passes through the probate process. For more information about probate read our MSU Extension MontGuide http://store.msuextension.org/publications/FamilyFinancialManagement/MT199006HR.pdf .

This MontGuide answers questions Montanans have asked about testamentary trusts.

What are the differences between a testamentary trust and a revocable living trust?

A **revocable living trust** is a legal arrangement by which an individual shifts ownership of property (such as securities, a home, real estate, bank accounts, certificate of deposits, stocks, bonds) from personal ownership into the legal ownership of the trust. A revocable living trust is just what the name implies – one that a person creates during life for one or more beneficiaries. The person who set up the revocable trust can change or end it at any time. For more information, read MSU Extension MontGuide *Revocable Living Trusts* (MT199612HR), https://store.msuextension.org/Products/Revocable-Living-Trusts__MT199612HR.aspx.

The term **testamentary trust** describes a trust created by a written Will. The property first passes through probate. Then the personal representative transfers the property to the testamentary trust. Both the revocable living trust and testamentary trust say how the trustee must distribute any assets in the trust to the beneficiaries after the settlor's death.

Settlors of both testamentary trusts and revocable living trusts make similar decisions about who trust beneficiaries are to be, standards for distributions to those beneficiaries, decisions about naming trustees and successor trustees, and any special directions.

What assets can pass to a testamentary trust?

The settlor can specify in a Will which assets pass to the testamentary trust after the settlor dies. Like the settlor of a revocable trust, the settlor of a testamentary trust can transfer most any kind of asset into a testamentary trust.

Additionally, life insurance policies, annuity policies, and pensions may allow the policy holder to list a testamentary trust as the beneficiary to receive the proceeds. Check with each company's policy to find if this beneficiary option is available.

Who can be a settlor of a testamentary trust?

A **settlor** is a person who creates and funds a trust. A settlor can be anyone who is age 18 and older. A settlor can change the terms of the testamentary trust at any time before death by making a new will or adding a codicil to the existing Will. A **codicil** is a supplement, amendment, or addition to a Will executed with all the formalities of the Will itself. The **codicil** may explain, change, add to, subtract from, qualify, alter, or revoke provisions in a Will.

What can the settlor specify in a Will?

A settlor outlines the terms of a testamentary trust in a written Will. The settlor can specify:

- the **trustee(s)** and **successor trustee(s)** to manage the testamentary trust assets.
- the **beneficiaries** who receive money or other property from the testamentary trust.
- when the trustee may use trust assets for the beneficiaries' benefit, such as distributing income to pay the beneficiaries' living expenses.
- whether the beneficiaries receive only the interest on the trust investments or whether the beneficiaries also may receive principal (assets) under stated circumstances.
- conditions for ending the testamentary trust, and
- the beneficiaries (persons or organizations) to receive the testamentary trust assets when the trust ends.

Who can be a beneficiary of a testamentary trust?

The settlor can choose any person or organization to be a beneficiary of a testamentary trust.

- minor children and/or adult children who have not reached financial maturity,
- adult children and/or other family members with disabilities, or debilitating health conditions such as Alzheimer's disease,
- children from a prior marriage, or
- a surviving spouse for the surviving spouse's lifetime and the ultimate beneficiaries of the trust assets after the surviving spouse dies (e.g., the settlor's children). For more information see MSU Extension MontGuide: *Using Trusts in an Estate Plan to Provide for Children from Blended Families.* **https://store.msuextension.org/publications/FamilyFinancialManagement/MT202109HR.pdf**

Minor children as beneficiaries: Montana law allows minor children to inherit property. If the property needs management while the child is still a minor, the court will appoint a conservator. The conservatorship ends when the minor child reaches age 18 and the conservator releases the property to the child.

Some parents and grandparents consider age 18 to be too young for a child to take control of a large sum of money or other property. Two alternatives are (1) to continue the trust (management by the trustee or successor trustee) as described later, and (2) to provide that property pass to custodial accounts for the children under the **Montana Uniform Transfers to Minors Act (UTMA)**. For more information, read MSU Extension MontGuide *Montana Uniform Transfers to Minors Act (UTMA): Custodial Accounts for Children Under Age 21* (MT199910HR), **https://store.msuextension.org/Products/Montana-Uniform-Transfers-to-Minors-Act-(UTMA)-Custodial-Accounts-for-Children-Under-Age-21__MT199910HR.aspx**

Under UTMA separate accounts are set up for each child. UTMA uses the term **custodian** for the person who manages the account for the child. The custodian can spend as much of the money as the custodian considers appropriate for the child. The custodianship ends when the child reaches age 21. At that point, the custodian turns over the assets to the child.

Even at age 21, many children lack financial maturity to manage a large inheritance. Thus, parents, grandparents, and other relatives may choose to leave assets in a testamentary trust for the child's benefit. This estate planning tool allows the trustee to give money or property to the child outright later in life. At the same time, the trustee can provide current benefits to the child until the child reaches a specified age.

Example 1—Minor Children: Eloise and Jack have three children under the age of 18. As a part of their estate plan, their attorney recommended Eloise and Jack each include identical testamentary trusts in their Wills for the benefit of their minor children upon the death of the surviving spouse. When the surviving spouse dies, the Wills specify individual trusts for each of their three children. The trustee may distribute trust funds for each child's health, education, maintenance, and support.

Eloise and Jack specified each individual testamentary trust ends when each child reaches age 30. When the child reaches age 30, the remaining trust assets in the individual child's trust pass to the child outright. By setting up a testamentary trust for each child, the older children do not need to wait for the youngest to reach the age the settlor designated when the trust ends.

Another possibility is one testamentary trust that helps all children. The trust ends when the youngest child reaches the designated age. This type of testamentary trust is more complicated than separate trusts for each child.

In either type of testamentary trust for young children, Eloise and Jack could permit the trustee in the Will to make discretionary distributions for their children to buy a home, a vehicle, or other lawful purpose, in addition for their health, education, maintenance and support. The settlor can include other instructions in the Will.

Family member with a disability, dementia, or other debilitating health conditions: When arranging finances for a family member with these health conditions, advice from an attorney with experience in disability planning and testamentary trusts is important. Relevant federal and state laws and regulations affect planning options.

A qualified attorney can help family members weigh advantages and disadvantages of such a "special needs" testamentary trust. The attorney would draft the trust to avoid making the family member with special needs ineligible for government programs and benefits.

Example 2—Family member with disability or debilitating health condition: Laurie and Sam have a child who has Down Syndrome. They named Laurie's sister as trustee of their testamentary special needs trust. Laurie's sister is well-informed about the needs and care of a child

who has Down Syndrome. After the death of Laurie and Sam's child, the trustee distributes the remaining trust funds according to their wishes written in their Wills. They named the Montana Down Syndrome Association as the beneficiary of the remaining trust assets.

Children from a prior marriage. Second (or later) marriages are common. Often spouses want to support each other after the first spouse dies. However, they want to make sure children from their prior marriage receive specific properties or a percentage of the assets after the surviving spouse dies.

Example 3—Protect children from a prior marriage: A married couple, Carol and Bill, each have children from their earlier marriages. If either should die, both want to financially support the surviving spouse and their children from a prior marriage.

Carol's written Will stipulates her land in sole ownership that she inherited from her parents will go into a testamentary trust for Bill's benefit during his lifetime. The trustee will use income from the trust for Bill's health, education, maintenance, and support for the rest of Bill's life. Upon Bill's death, the trust ends, and the trustee distributes the land to Carol's children.

Similarly, Bill's written Will provides for his property to pass into a testamentary trust for Carol's benefit. The trustee will use income from the trust assets and the principal for Carol's health, education, maintenance, and support for the rest of her life. Upon Carol's death, the trust ends, and the trustee distributes the remaining assets to Bill's children from a prior marriage.

As a result, either surviving spouse has income from the "first-to-die" spouse's property and the principal is preserved to ultimately benefit the "first-to-die" spouse's children.

Surviving Spouse with Alzheimer's disease, other form of dementia, or a debilitating health condition: Another use of a testamentary trust is for a caregiver spouse. Because many seniors die with Alzheimer's or related dementia, or other debilitating disorders, caregivers may consider a testamentary trust whereby a trustee manages property for the impaired surviving spouse.

The caregiver's Will could direct property into a testamentary trust. The trustee manages the assets for a surviving spouse who does not have the mental capacity to make financial decisions. The trustee can also use the funds to pay for health insurance and living costs for the surviving, disabled spouse.

Example 4—Surviving spouse with dementia: Sara's physician diagnosed her with a late stage of Alzheimer's disease. Sara's husband signed his written Will that includes a testamentary trust for Sara's benefit. The trustee, their daughter, follows the Will directive to use the funds in the testamentary trust to pay for her mother's care in a memory care unit and for any other items she may need. The Will includes a provision for the trustee to give any funds remaining after Sara's death to the Alzheimer's Association.

Example 5—Surviving spouse with debilitating health condition: Paula's husband, Sam, has Parkinson's, a debilitating disease. Paula is his caregiver. Sam no longer has the skill nor the ability to manage assets.

Paula set up a testamentary trust in her Will. In the Will, Paula instructs the trustee to use the assets for Sam's care until he dies. After Sam's death, the trustee is to distribute the remaining assets to the Montana Parkinson's Foundation.

Does the title of property control whether it can pass to a testamentary trust?

Definitely. How a settlor titles property makes a difference whether the asset can pass to a testamentary trust. There are three basic forms of property ownership typical to Montana families: Sole ownership, joint tenancy with right of survivorship and tenancy in common. For more information see MSU Extension MontGuide, *Property Ownership: Estate Planning* http://store.msuextension.org/publications/FamilyFinancialManagement/MT198907HR.pdf.

Property titled in the name of the deceased only **(sole ownership)** passes through probate. Probate is a process to validate the settlor's will and assure payment of the deceased's debts. The personal representative retitles the assets from the name of the deceased to the name of the testamentary trust.

Two or more persons could hold an **undivided interest** in the same property as **tenants in common** with no right of survivorship for the surviving tenant. **Undivided interest** means each person owns a fraction or percentage of the total value. The settlor could provide in a Will that the settlor's share transfers to the testamentary trust. The other share would remain with the other co-owner(s).

Property held as **joint tenancy with right of survivorship** (JTWROS) automatically passes to the surviving joint tenant. The Will of a deceased joint tenant does not control the disposition of the joint tenancy property. This is true even though the Will

could read, *"My share of the joint tenancy property is to pass to my testamentary trust."* **The joint tenancy with right of survivorship title takes priority over the Will.**

The surviving joint tenant is free to transfer property to a testamentary trust created in the surviving joint tenant's Will. However, the surviving joint tenant does not have to do so. The surviving joint tenant could write a Will to leave the property to anyone or any organization.

Example 6—Joint tenancy with right of survivorship: Joe and Debbie own a home in Bozeman. The deed states they own the house as *joint tenants with right of survivorship* and not as *tenants in common*. If either of them dies, the survivor receives the deceased's joint tenancy interest in the home.

They agree at their deaths they want the house sold and the proceeds used to support Debbie's mother who has Alzheimer's disease. The attorney recommended their Wills have identical testamentary trust language. Upon the death of the surviving spouse, the testamentary trust will support Debbie's mother during her lifetime (unless the survivor of them changes the survivor's Will). After Debbie's mother dies, the trustee distributes the remaining property according to the Will to the Alzheimer's Association.

Who can be a trustee of a testamentary trust?

The **trustee** of a testamentary trust can be a surviving spouse, a friend, a family member, a corporate entity *(such as a bank or trust company)* or any combination of these. The trustee should be someone with whom the settlor has a high degree of confidence about their ability to manage the assets in the trust for the benefit of the beneficiaries.

What are the duties of the trustee of a testamentary trust?

A trustee must administer a testamentary trust according to the provisions of the written Will and Montana law. Montana law requires the trustee to function as a **fiduciary.** This means the trustee has the duty to manage the money and property in the trust solely for the beneficiary's benefit, not for the trustee's benefit. The trustee must honor the settlor's financial wishes and pass property to the beneficiaries as the settlor outlined in the Will.

The legal requirement for a trustee includes four basic duties:

1. Act only in the best interest of the beneficiary.
2. Manage the money and property in the trust prudently.
3. Keep the trust property separate from the trustee's property.
4. Keep good records of money and other property coming in and going out of the trust.

If the settlor names more than one person as a trustee, they become **co-trustees.** The written Will should say whether co-trustees can make decisions individually or whether they must agree on decisions. Also, the Will should say whether the decisions must be unanimous or by majority rule. If one co-trustee dies, the other one(s) will assume all responsibilities.

The settlor should name at least one **successor trustee** in the Will. This person takes over only if the trustee named first resigns, can no longer fulfill the role, or dies.

How does the settlor explain to the trustee about acceptable uses for funds in the testamentary trust?

The settlor sets the rules for trust distributions in the written Will. A settlor can give the trustee broad authority to distribute trust property to beneficiaries at specified times, such as graduation from college, marriage, or birth of a child. Or the settlor can simply direct the trustee to distribute only income earned on the trust property with the goal to preserve the principal.

Estate planning attorneys often suggest their clients take advantage of a testamentary trust's flexibility by giving the trustee broad decision-making authority. For example, just as a parent has many options when financially supporting children, the settlor may give the trustee similar choices.

Some settlors want to be more restrictive and limit the trustee's power or set a maximum amount of money to give to the beneficiaries. As a result, the settlor could give the trustee little, if any, discretion over distributions. These decisions are based on the confidence the settlor has in the trustee and the settlor's goals for the testamentary trust.

If the settlor plans to give the trustee broad authority in the Will, the settlor could have a face-to-face discussion with the trustee. This conversation could help the trustee understand the settlor's preferences.

Example 7—Beneficiary and further education: Noah wants his trustee to consider his grandchildren's future requests to support their "further education" after they graduate from high school. Because Noah has confidence in the trustee, he provides in his Will for the trustee to have "absolute discretion" whether to grant or not to grant, his grandchildren's requests.

Noah met with his trustee to discuss what is meant by "further education" in the Will. They discussed whether "further education" includes a certificate program, a degree from a technical school, or an academic or professional degree. They also explored whether a request from a grandchild for a trip abroad is "further education" and worthy of a distribution from the trust.

Because of the discussion, the trustee knows Noah's thinking about "further education." Although the conversation is not legally binding, knowing Noah's views will help the trustee honor the settlor's wishes.

Settlors can also include testamentary trust provisions to encourage certain actions the settlor believes is important. For example, parents who want to encourage their children to attend college could include a provision in their testamentary trusts giving children extra money and a lump sum distribution when earning a bachelor's, master's, or doctoral degree. If the children do not receive the specified degree, the settlor typically directs the trustee to distribute the money to the child at a specified age.

What happens if the trustee does not accept the trustee nomination or resigns?

If the trustee does not accept the trustee nomination or resigns prior to the conclusion of trust administration, the beneficiaries should examine the Will to learn if the settlor named a **successor trustee.** If the settlor did not name a successor trustee in the Will, a district court proceeding may be necessary to appoint a successor. Naming at least one successor trustee in a written Will is prudent.

What does a testamentary trust cost?

The cost to set up a testamentary trust depends on the complexity and time involved to develop a Will to include trust provisions. Legal fees could range from $1,000 to $8,000 or more. Ask an attorney about fees charged for including a testamentary trust in a Will.

What do corporate trustees charge to manage a testamentary trust?

Families who do not have members with the legal and financial backgrounds to manage a trust may decide to use a corporate trustee. Many corporate trustees charge a **set-up fee** that may range from $1,000 to $2,500.

Corporate trustees also charge **annual management fees** to manage trusts. The charge ranges between 1.0% and 1.5% of the value of the trust assets per year. The fee may vary based on type of property under the trustee's supervision. For example, the cost may be higher if the corporate trustee is managing a ranch/farm business or rental complex compared to investing in publicly-traded stocks, bonds, and mutual funds.

Most corporate trustees charge management fees on a sliding scale, with a decreasing percentage as the asset value in the testamentary trust increases. Some corporate trustees set up a **minimum value of assets** before they accept management of a trust.

Ask potential corporate trustees for their requirements, the amount of any set up fees, and annual maintenance fees. You may wish to visit with one or two before choosing which corporate trustee would manage your trust.

Does a testamentary trust have to pay income taxes?

Yes! If the assets in a testamentary trust earn income during the tax year and the trustee does not distribute it to the beneficiaries, the income is subject to state and federal income taxes. The trustee files an annual fiduciary income tax return for the trust (Form 1041) at the federal level and a Montana Income Tax Return for estates and trusts (Form FID-3).

When a trustee distributes assets from the testamentary trust to beneficiaries, the beneficiaries must list a part of the distributions received as income on their individual income tax returns. The trustee deducts the same amount of income on the trust income tax return. As a result, the income is not taxed twice.

The trustee should send an annual income tax statement to the trust beneficiaries. This is Schedule K-1 (Form 1041) --- Beneficiary's Share of Income, Deductions, Credits, https://www.irs.gov/forms-pubs/about-schedule-k-1-form-1041. If the trustee does not file the correct form or does not pay the tax by April 15, the trustee can be personally liable for interest and penalties. If the trustee does not make distributions to beneficiaries in a taxable year, the trustee pays taxes on income earned in the trust.

Can beneficiaries change a testamentary trust after the settlor's death?

Generally, no. The Montana legislature has passed statutes allowing for the change or termination of a trust under **extremely limited circumstances and requires action by the district court.** For example, the district court can end a testamentary trust with the consent of all the beneficiaries. But this action is possible only if the district court concludes continuance of the trust is not necessary to achieve the material purpose outlined by the settlor. If the court ends the trust, the trustee distributes the assets in the trust to the named beneficiaries.

There are also provisions in Montana law for ending a trust having a total value less than $100,000. If the trustee concludes the value of the trust property is not enough to justify the costs of trust administration, the trustee can distribute the property to the beneficiaries. If, however, the beneficiary does not have the mental competency to make financial decisions, the court may appoint a conservator to continue to manage the assets for the beneficiary.

Summary

A Montanan can include a testamentary trust in a written Will. The testamentary trust does not go into effect until the death of the settlor. The settlor selects the trustee and successor trustee to manage the trust assets. The settlor chooses the beneficiaries and decides when income and assets pass to them. A settlor can change the terms of the testamentary trust at any time before the settlor's death by changing the Will or amending the Will with a **codicil.**

Acknowledgements

Representatives of the following reviewed this MontGuide. They recommend its reading by individuals interested in learning about basis in property.

- Business, Estates, Trusts, Tax and Real Property Section (BETTR), State Bar of Montana
- Montana Society of Certified Public Accountants
- The Jake Jabs College of Business and Entrepreneurship, Montana State University
- Department of Agricultural Economics and Economics, Montana State University
- Montana State University Extension Agents
- Montana participants in Wisdom Wednesdays webinars sponsored by MSU Extension and AARP

Disclaimer

This publication is not a substitute for legal and tax accounting advice. Rather, the intent is to help Montanans become better informed about testamentary trusts. Because the Montana legislature may change laws in the future, statements in this MontGuide are based solely on the statutes in force on the date of publication.

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