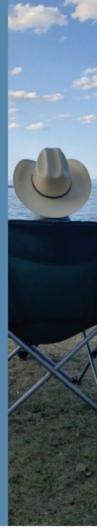
MONTANA STATE UNIVERSITY EXTENSION

MontGuide



Patti Goroski

FAMILY FINANCIAL MANAGEMENT

MT202109HR, CURRENT AS OF 7/21

Using Trusts in an Estate Plan to Provide for Children from Blended Families

By Joel Schumacher, Montana State University (MSU) Extension Economics Associate Specialist; and Marsha A. Goetting, MSU Professor and Family Economics Specialist - both Dept. of Agricultural Economics and Economics

While estate planning is an important issue for Montana families, blended families bring unique challenges to the process. Testamentary and Clayton Election Qualified Terminable Interest Property (QTIP) trusts are alternatives to help blended families achieve a variety of estate planning goals.

MONTANA FAMILIES ARE MADE IN DIFFERENT FORMS. Some are more traditional first-time married parents with biological children from that marriage. Other families, which may have children from an earlier marriage who are "his," "hers," and/or "theirs," have come to be known as blended.

Blended families bring unique challenges to the estate planning process. Complex relationships often exist among family members. Financial issues can result in family discord. Another challenge is rooted in Montana laws governing who inherits property when the deceased family member did not have a written will or other document listing beneficiaries. While these laws often align closely with the estate planning goals of a traditional family, they are less likely to address the complex issues of blended families.

A will that includes a testamentary trust can help blended families create an estate plan to meet goals of passing specific property to specific heirs. The property in the testamentary trust can provide income for the surviving spouse during lifetime. And, after the death of the surviving spouse, allow the remaining testamentary trust property to pass to desired heirs.

Estate plans to accomplish these goals may incorporate one or more types of testamentary trusts: bypass trust, credit shelter trust, Qualified Terminable Interest Property (QTIP) trust, marital trust, family trust, A-B trust structure, or A-B-C trust structure. This MontGuide focuses on the use of a will or Revocable Living Trust with a testamentary trust commonly referred to as a Clayton Election QTIP trust.

Exploring estate planning options for a blended family

Karen and Bill operate a farm Karen inherited from her father. The value of the farm is $1.2 million. Karen has the farmland titled in her name as sole owner. Their estate also consists of other non-farm assets valued at $400,000. Karen and Bill have titled these assets as joint tenants with rights of survivorship.

Karen and Bill each have an adult child from an earlier marriage. They have agreed they want Karen's daughter to inherit the farm because she has been involved in its operation for a decade. They want Bill's son and Karen's daughter to share the non-farm assets equally.

Karen and Bill do not have a premarital agreement, written will or any other type of estate plan. They recently attended an MSU Extension estate planning online seminar where they learned if they do not write a will, at death their property passes to heirs according to Montana intestacy statutes. They reviewed the MSU Extension MontGuides *Dying Without a Will in Montana* (MT199808HR) (http://store.msuextension.org/publications/FamilyFinancialManagement/MT198908HR.pdf) and *Property Ownership* (MT198907HR) (http://store.msuextension.org/publications/FamilyFinancialManagement/MT198907HR.pdf) to learn the state's plan for the transfer of their property.

What if Karen dies first without a written will?

If Karen dies before Bill, all $400,000 of the non-farm assets transfer directly to Bill. Why? Because Karen and Bill titled their non-farm assets in joint tenancy with right of survivorship. Under Montana law at the death of one of the joint tenants, the survivor receives all.

Even if Karen had written a will with a provision passing the non-farm assets to her daughter and Bill's son, the joint tenancy with right of survivorship takes priority over the will. At Karen's death, Bill becomes the sole owner of the $400,000 of non-farm assets.

Because this example assumes Karen died without having a written will, her farm assets valued at $1.2 million and titled in her name only, pass according to Montana's intestacy statutes. Bill, as the surviving spouse, receives the first $225,000 in value of the farm assets, plus one-half of the remaining property ($487,500). The remaining one-half of the farm assets ($487,500) pass to Karen's daughter.

The result is Bill receives a total of $712,500 ($225,000 + $487,500 = $712,500) or 59 percent interest in the farm property Karen titled in her name only. Karen's daughter receives the remaining $487,500 or 41 percent interest in the farm property. Karen's daughter and Bill will be running the farm together.

Bill's majority ownership (59 percent) gives him control over the farm operation. He could sell his interest in the farmland (even if Karen's daughter does not agree) or gift his interest to his son or to his favorite nonprofit. Bill's total inherited assets upon Karen's death are $1,112,500 ($712,500 farm assets + $400,000 non-farm assets = $1,112,500). Bill's son (Karen's stepson) receives nothing upon Karen's death.

If Bill dies several years after Karen and if he did not write a will, then Bill's son receives Bill's 59 percent interest in the farm. His son also receives all the non-farm assets (valued at $400,000) Bill inherited at Karen's death. Karen's daughter and Bill's son would then become co-owners of the farm with a 41 percent and 59 percent, respectively. This is not the outcome Karen and Bill want.

What if Bill dies first without a written will?

If Bill dies before Karen and if he does not have a written will, the $400,000 of non-farm assets transfer directly to Karen. Why? Because Karen and Bill have the assets titled as joint tenancy with right of survivorship. At the death of one of the joint tenants, the survivor receives all.

Even if Bill had written a will saying the non-farm assets were to pass to his son and Karen's daughter, the joint tenancy with Karen takes priority over his will. At Bill's death Karen becomes the owner of $400,000 of the non-farm assets.

Because Karen has the title of the farm property in her name only, Bill's death has no effect on this property. After Bill's death, Karen now owns all the assets. Bill's son would not receive any property following his father's death.

Assume several years later Karen dies without a will. Karen's daughter inherits the entire estate based on Montana's intestacy statutes. Bill's son would not receive any property following his stepmother's death. This potential outcome is also not what Karen and Bill want.

Developing an Estate Plan for a Blended Family

Karen and Bill decided to share their concerns with an attorney whose focus is estate planning. After a discussion of Karen and Bill's estate planning goals, the attorney explained they have several options.

The first option would use a will for both Karen and Bill. While this option is simple and easy to implement, a will alone may not meet Bill and Karen's goal of providing an **equitable** division for their respective children.

A second option would use a will with a testamentary trust. While this option is more complex, using both tools will help ensure Karen's daughter and Bill's son will receive the specific assets their parents want them to receive.

A third option offers an additional estate planning tool, a Clayton Election QTIP (Qualified Terminable Interest Property) trust. While this option is the most complex of the three, the trust is helpful to the beneficiaries as it enables them to avoid capital gains taxes if they sell the inherited property. A QTIP trust also has added flexibility in anticipation of future federal estate tax law changes.

Estate Plan Option #1: Write a will for each spouse.

The attorney informed Karen and Bill a written will can address most of their concerns. For example, Karen's will could say if Bill is living when she dies, the farmland assets she has titled in sole ownership pass to her daughter. The remaining non-farm assets held in joint tenancy with right of survivorship with Bill would pass outside the will directly to Bill. If Bill is not living when Karen dies, her will could have a provision dividing the non-farm assets equally between Bill's son and her daughter.

Bill could also write a will. Bill's only properties are the non-farm assets held in joint tenancy with right of survivorship with Karen. If Bill were to die first, his will has no assets for the will to direct. The joint tenancy with right of survivorship title on the non-farm assets means they automatically transfer to Karen. However, if Karen dies first, Bill's will determines the distribution of the non-farm assets. Bill's will could have a provision for his son and Karen's daughter to share the non-farm assets equally.

Both wills could have a provision saying if they die in a common accident, their non-farm assets pass equally between Bill's son and Karen's daughter.

Although this plan meets Bill and Karen's estate planning goals, it has several disadvantages. *First,* if Karen dies before Bill, the farm assets pass according to her will to her daughter. Because Karen's daughter would own the farm, Bill may find himself in the uncomfortable position of having to ask Karen's daughter for permission to remain in the house on the farm. Will the daughter agree? Would she charge Bill rent? Who pays for the property taxes and insurance? What if Karen's daughter decides she wants to live in the house? Karen's daughter could force Bill to move. Karen and Bill quickly realize this option is not to their liking.

Second, if Karen's daughter decides to sell the farm, Bill could not prevent her from doing so because he is not the owner. Now where would Bill live? Where could he afford to live? Karen and Bill are concerned about these potential outcomes even though they seem remote at the present time. Both believe they have positive family relationships between them and their children.

Estate Plan Option #2: Use wills or Revocable Living Trusts to create testamentary bypass trusts for each spouse.

Another option is an estate plan with the addition of a testamentary bypass trust provision to each of Karen and Bill's wills or Revocable Living Trust. This plan is more complex than Option 1, but it provides additional choices for Karen and Bill. This more advanced estate plan would require a Personal Representative or Trustee to direct specific assets to a testamentary bypass trust (sometimes known as a family trust or credit shelter trust) at the death of the first spouse.

Attorneys refer to this as a bypass trust because the assets are included in the estate of the first spouse to die, thus, bypassing the estate of the second spouse to die. In prior years, individuals used such trusts to minimize federal estate taxes. Today, however, the increase in the federal estate tax exemption ($11.7 million in 2021) and the introduction of portability have removed this motivation for using only bypass trusts in estate plans.

For couples who expect to have estates valued collectively at more than $23.4 million (the federal estate tax exemption for a married couple in 2021) planning for minimization of the federal estate tax can still be a key factor. For 99% of Montanans, however, the federal estate tax is not an issue now. More information about the federal estate tax can be found in the MSU Extension Montguide, *Federal Estate Tax* (**MT199104HR**). **http://store.msuextension.org/publications/FamilyFinancialManagement/MT199104HR.pdf**

The bypass trust usually includes a provision allowing the surviving spouse to continue to use the assets placed in the trust and to receive income distributions of assets of the trust during the remainder of his or her lifetime. After the second spouse dies, the trustee transfers the assets to the beneficiary(ies) as required in the will or a Revocable Living Trust that created the bypass trust.

As an example, Karen's will or Revocable Living Trust could state if she dies before Bill, then the farm assets transfer to the bypass trust for the lifetime benefit of Bill and for the ultimate benefit of her daughter. The provisions of the bypass trust could allow Bill to live in the house rent free and to receive the income from the farm assets. The trust could pay the property taxes.

After Bill dies, the trustee would distribute the farm assets to Karen's daughter as directed in the document that created the bypass trust. Thus, with the testamentary trust Karen has the security of knowing Bill will have the use and benefit from the farm assets until his death. And, Karen can guarantee her daughter will receive the farm assets. The downside, however, is Karen's daughter will not receive the most favorable tax position upon receiving the farm assets, especially if Bill outlives Karen by many years.

Estate Plan Option #3: Write wills or Revocable Living Trusts for each spouse with a provision for a Clayton Election QTIP trust.

The attorney then explained to Karen and Bill how a Clayton Election QTIP trust would be most helpful for their situation. In prior years, married couples used Clayton Election Trusts to minimize federal estate taxes. Now married couples can use these trusts to reduce capital gain taxes for the beneficiary of the property if or when they sell the property.

One of the benefits of the Clayton Election QTIP trust is the **step-up in basis** at the surviving spouse's death. This means the cost basis of the property eventually passing to Karen's daughter will be based on the farm's fair market value at the time of Bill's death and then again at the time of Karen's death (often referred to as a **double step-up**).

Assume the value of the property was $1.2 million upon Karen's death at the time it transferred to the QTIP trust. Then by the time Bill died, the property had increased in value to $2 million. Karen's daughter inherits the farm at the stepped-up value of $2 million. If Karen's daughter sells the property for $2 million there is no capital gain because of the step-up in basis at the death of Bill. Karen's daughter would not owe a capital gain tax because there is no capital gain on the sale of the farmland.

However, if Karen's daughter sells the farm a couple of years after Bill's death for $2.2 million, then she would have a capital gain of $200,000. Karen's daughter would pay state and federal capital gains tax on that amount.

The assets in the Clayton Election QTIP trust qualify for the unlimited federal estate tax marital deduction because there is no limit to the amount one spouse may gift to the other spouse. The Personal Representative or Trustee makes an election to treat certain property as qualified terminable interest property. A Clayton Election appears on the decedent's final Form 706 filed within 15 months following the deceased's date of death (the general deadline of nine months following the deceased's death, plus a six-month automatic extension).

The Personal Representative or Trustee passes the farm assets to the QTIP trust for Bill's benefit during his life. He has some control over these assets while he is living, but he cannot give or sell the property to anyone else as he cannot change beneficiaries of the QTIP trust. The document established by Karen authorizes property in the QTIP trust to pass to her daughter upon Bill's death.

If Bill remarries, he cannot place the assets in the QTIP trust in his new wife's name. Nor, can Bill give away the property to anyone or any non-profit. The property in the QTIP trust does not belong to Bill. He only has the right to use the property during his life. Because of the federal estate exemption of $11.7 million (the individual estate tax exemption in 2021), there is no federal estate tax due upon Karen or Bill's death.

The use of the QTIP trust allows Karen and Bill to enjoy the use of the farm during their lifetimes and for Karen's daughter to inherit the farm without paying federal estate taxes and with fewer income tax consequences. The QTIP election maximizes the basis for determining the potential capital gain taxes if Karen's daughter ever chooses to sell the farm.

Conclusion

A will alone often does not accomplish a blended family's estate planning goals. A will with a testamentary trust combines two tools to help parents in creating an estate plan to meet their goals for passing property to specific children. The property in the trust can provide income for the surviving spouse during their lifetime. After the death of the surviving spouse, the property passes to the desired heirs.

A Clayton Election QTIP trust may not be the right estate planning tool for all couples. However, it may help blended families minimize future capital gain taxes and determine the best course of action regardless of whatever future tax law changes occur.

References

Garrison, Scott. *Flexible estate planning: Disclaimer trusts and the Clayton QTIP election,* http://thenautilusgroup.com/nautilusnavigator/disclaimertrusts andclaytonqtip.pdf Download October 5, 2020

Truemann, Kimberly Ann. September 18, 2020. When would I use a QTIP trust? https://www.avvo.com/legal-guides/ugc/when-would-i-use-a-qtip-trust- Download October 5, 2020.

Lifetime QTIP Trusts, November 16, 2015, Bryan Law Firm, PC. https://bryanlawpc.com/lifetime-qtip-trust/ Download October 5, 2020.

Other resources

For additional information about estate planning visit the MSU Extension estate planning website at: www.montana.edu/estateplanning.

Acknowledgement

Representatives of the Business, Estates, Trusts, Tax and Real Property (BETTR) Section of the State Bar of Montana have reviewed this MontGuide. They recommend its reading by Montanans who are interested in an introduction to how trusts could achieve various estate planning goals. The BETTR Section encourages all persons considering a trust to obtain competent legal advice.

Disclaimer

This publication is not a substitute for legal or tax advice. Rather, it helps families become better acquainted with how wills and trusts can achieve certain goals in estate plans. Future changes in state and federal laws will undoubtedly occur, so statements within this fact sheet are based solely upon those laws in force on the date of the publication.

MONTANA STATE UNIVERSITY | EXTENSION

MT202109HR, CURRENT AS OF 7/21
FAMILY FINANCIAL MANAGEMENT (ESTATE PLANNING)