TESTAMENTARY TRUSTS

Background

A testamentary trust is a trust that springs forward upon the death of an individual. While "living trusts" are a common legal mechanism for setting forth how an individual's assets are to be distributed upon his or her death, that type of trust is created and is effective during the individual's lifetime. A testamentary trust, on the other hand, only springs into existence upon the death of the individual creating the trust. The instructions for a testamentary trust may be set forth in either a living trust or a last will and testament.

Once an individual has designated a beneficiary to receive all or a portion of his or her assets upon death, the next decision to be made is when the beneficiary will receive those assets. The beneficiary may receive his or her inheritance outright or a testamentary trust may be created to hold the assets earmarked for the beneficiary so that those assets can be distributed out to the named beneficiary over time. Thus, a testamentary trust is essentially a set of instructions that govern how the assets intended for a specified beneficiary are to be administered and under what conditions or when those assets may actually be distributed to the beneficiary.

Mechanics

In order to create a testamentary trust, an individual must first execute a last will and testament or a living trust agreement that will house the instructions for the testamentary trust. In their will or living trust the individual may then spell out the specific instructions for their testamentary trust that will direct how the specified assets are to be held and administered for the named beneficiary. When designing a testamentary trust there are essentially 3 types of instructions that can be incorporated into the trust. A testamentary trust can contain all 3 types of instructions or just one or two of the types of instructions. Those instructions are:

① The ability to make discretionary distributions from the trust for specified needs (such as medical or educational expenses).

② The ability to provide a payment stream on a monthly, quarterly or annual basis (either the income generated by the trust assets or a "unitrust" payment).

③ The ability of the beneficiary to receive lump sum distributions at specified ages or events (i.e. receive 1/2 of the trust at age 25 and 1/2 at age 30, or to receive $xxx upon graduation from college).

A summary of the different options available under each of these types of instructions is as follows:

Discretionary Distributions

When creating a testamentary trust, it is necessary to designate a trustee to oversee and carry out the instructions of the testamentary trust. One of the instruction options that may be used in a testamentary trust is to grant the trustee the ability to make distributions to the named beneficiary on a discretionary basis for specified needs. The discretionary authority granted to a trustee may be very narrow (*i.e.* authority to make discretionary distributions for medical needs only) or it may be very broad (*i.e.* authority to make discretionary distributions for the happiness and best interests of the named beneficiary).

The age of a named beneficiary will often have an impact on these decisions. A testamentary trust created for a minor beneficiary may include discretionary authority to make distributions for the basic living needs and educational needs of that minor beneficiary. A testamentary trust created for an adult beneficiary which is intended primarily as an asset protection vehicle may include very broad discretionary authority, such as the ability to make distributions for the purchase of a residence, start up of a business, and/or travel.

In some instances, such as when a beneficiary is not fiscally prudent or who may have drug or alcohol addiction problems, it may be necessary to restrict discretionary distributions to direct payments to the provider of goods or services so that no money is paid directly to the beneficiary. A general outline of some of the more common discretionary authority is as follows:

Medical	Living	Education	Real Estate	Miscellaneous
Doctor	Food	Private School	Down Payment	Best Interest
Dental	Clothing	Trade School	Pay Off Mortgage	Start Business
Surgery	Rent	College	Property Taxes	Travel
Insurance		Graduate	Repairs	Car Buy/Repair
Medication		Continuing Ed	Insurance	Cultural/Rec
Vision		Grandchildren	Improvements	
Nursing Home		Pay Loans		
Mental Health				
Child				
Spouse				

Payment Stream

Unlike discretionary distributions, which must generally be requested by a beneficiary, a payment stream is a distribution that will occur automatically on a consistent basis. A payment stream may be directed in one of two ways:

① Payment of income generated by the testamentary trust; or

② Payment of a "unitrust" amount based on the value of the testamentary trust.

Once assets are placed in a testamentary trust, it is the duty of the trustee to invest those assets. As a result, the invested assets will generate income on an annual basis. That income may take the form of interest (*i.e.* from bonds or CDs) or dividends (*i.e.*

from stocks and mutual funds). One method of creating a payment stream would be to direct that any such income be paid out to the beneficiary on a monthly, quarterly or annual basis.

One perceived disadvantage of directing that the "income" be paid out to a beneficiary is that the assets of the testamentary trust will have to be invested in a manner that will maximize the income generated. Thus, instead of investing the assets in a diversified portfolio consisting of stocks, mutual funds and bonds, the assets will have to be invested primarily in bonds, CDs, treasuries and similar fixed assets which will maximize the return of income - but at the cost of any real growth.

Where the creator of the testamentary trust would like to provide a payment stream and maximize the overall return of the trust assets, the better approach is to require the payment stream to be based upon a "unitrust" calculation. This requires the trustee to multiply the January 1st balance of the trust by a pre-determined percentage (typically between 2% and 5%). That number will then determine the amount of the payment stream for that year.

> *For example, a testamentary trust with a $400,000 balance and a 3% unitrust percentage would require an annual payment to the beneficiary of $12,000 ($400,000 x 3%), or $1,000 / month. The beneficiary would then receive a check for $1,000 on the first day of each month.*

By not directing the trustee to pay the income generated by the trust, the assets of the testamentary trust can be invested in a diversified portfolio that would hopefully result in a annual return of 7% to 10% over an extended period of time. Therefore, even if the trust makes a 3% payment to the beneficiary, the trust will still grow by another 4% to 7% (depending upon the return realized by the trust). That means in each successive year, the unitrust payment will increase (because the beneficiary is receiving 3% of a continually growing trust) so the payments keep up with inflation and do not lose purchasing power over time.

Distribution At Specified Ages or Events

In many instances, a testamentary trust is intended to last only for a specified period of time. Where an individual wants to make sure a beneficiary has simply obtained enough maturity and experience to handle a large some of money, they may direct the testamentary trust be paid out over a couple of installments (*i.e.* 1/3 upon the beneficiary attaining age 25, another 1/3 at age 30, and the final 1/3 at age 35). Where an individual wants to establish a testamentary trust to provide asset protection for a more mature beneficiary, they may set distribution ages at 50, 55 and 60 to ***guarantee*** the trust funds will be available to the named beneficiary upon their retirement, even if the beneficiary is divorced or involved in a lawsuit before those ages.

Distributions do not necessarily have to be based upon the age of the beneficiary. Distributions may also be directed upon specified events. For example, a beneficiary may be entitled to a specific dollar amount or a percentage of the trust balance upon graduation from college, or getting married, or upon the birth of a child.

There is, however, no requirement that a beneficiary's trust be distributed to them at certain times or events. Another option is to allow distributions to the beneficiary on a discretionary basis and/or under a mandated payment stream only. Upon the death of the named beneficiary, the remaining balance of his or her trust will then be held for the benefit of his or her children or such other beneficiaries as the creator of the testamentary trust may direct. This type of testamentary trust is often referred to as a "dynasty" trust or "generation skipping trust" because it may last for the benefit of several generations.

Asset Protection

While testamentary trusts have traditionally been used to provide for minor beneficiaries, in recent years they have become popular for older beneficiaries for the asset protection that is provided by these types of trusts. Given the high divorce rates in existence today, along with the number of lawsuits filed on an annual basis, many individuals are now focused on protecting their assets from these types of events as a key component of their estate plan.

When assets are distributed to a beneficiary, those assets become available to potential creditors, divorce proceedings, bankruptcy proceedings, and lawsuits involving the beneficiary. On the other hand, assets that remain in a testamentary trust for the benefit of that beneficiary are protected from these types of undesired events.

For example, in the event of divorce, "marital property" is legally defined as all property acquired by either spouse subsequent to the marriage, ***except*** the following, which is known as "non-marital property":

"property acquired by gift, legacy or descent"

The key, therefore, is to be able to clearly identify property that was received by inheritance. When that property is held in a testamentary trust there is no clearer way to identify that property as non-marital property.

Similar statutory protection is provided from creditors. Illinois specifically provides that:

> No court shall order the satisfaction of a judgment out of any property held in trust for the judgment debtor if such trust has, in good faith, been created by, or the fund so held in trust has proceeded from, a person other than the judgment debtor.

Since Illinois law states that no satisfaction of judgment can be ordered out of any property held in trust for an individual if the trust has been ***created by a person other than the individual***, establishing a testamentary trust can be a tremendous vehicle for providing asset protection. For an adult beneficiary who is not necessarily depending upon the trust assets for their daily support, establishing a testamentary trust can provide them with the ability to protect those inherited assets for use upon attaining retirement age.

Bloodline Protection

One additional benefit of implementing a testamentary trust is the ability to keep money in the "bloodline" for a longer period of time. If the named beneficiary of a trust dies before receiving the balance of their trust in full, the creator of the trust gets to direct where those remaining funds are to pass. They may provide, for example, that in that event the remaining balance of the trust will pass (or be held in trust) for the children of the named beneficiary. If, alternatively, the beneficiary had received their share outright, it is likely that the inheritance would pass to the beneficiary's spouse upon his or her death. If that surviving spouse remarried a few years later, and then died before the new spouse, the children of the original trust beneficiary would never realize any of the assets. By keeping those assets in a testamentary trust, the children of the original trust beneficiary are still assured of receiving the benefit of the inherited assets if the named trust beneficiary dies prematurely.

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Testamentary trusts can be created for a variety of reasons. The instructions of individual testamentary trusts may vary greatly - depending upon the intended purpose for establishing the trust. This is potentially one of the most powerful tools available in the estate planning process and it is important to consider all of the potential benefits that may be realized by including this type of trust in one's overall estate plan.

This document was prepared by:

AGNEW LAW OFFICE, P.C.
129 South Phelps Avenue
Suite 801
Rockford, Illinois 61108
(815) 399-3522