A STRATEGY SPOTLIGHT

Planning for the Financial Protection of Children and Young Adults

Almost everyone with young children knows that they should probably have both a Will and a trust, even if they don't completely understand exactly why. Married couples often believe that if something happens to one spouse, the other will be around to raise the children and to manage the family finances. Failure to adequately plan can have unintended consequences. Properly drafted estate planning documents can help to avoid those consequences.

Let's look at the hypothetical situation of a 30-year-old named Bruce. Ten years ago, when he was 20, his parents and siblings were killed in a car crash.

Bruce received his parents' life insurance death proceeds and retirement assets equal to about $500,000. Over the next three to four years, he purchased six different automobiles and generally "blew through" all of his inherited funds.

Eventually, he received another $350,000 from a settlement related to the accident. Being older and wiser, he used these funds to purchase a house and to set aside funds for his children's education. He deeply regrets that he essentially wasted the first $500,000.

Bruce's decision-making was not uncommon or really even unreasonable in light of his emotional state. At the age of 20, Bruce was legally an independent adult with full access to all of his financial assets. However, with proper advice, his parents could have structured his inheritance to be held in a trust, which would not only provide for its management and protection, but its trustee could provide Bruce with financial mentorship as well.

A similar problem can occur when young adults become owners of life insurance policies on their lives or other assets with significant value. Since the decision to purchase life insurance should be based on long-term goals and the need for death benefit, they may not fully appreciate the benefits that a life insurance policy provides and focus on how they can use the cash value through a surrender, withdrawal, or loan.[1] Life insurance is not an appropriate vehicle for short-term savings or short-term investment strategies. While the policy allows for loans, there may be little to no cash value available for loans in the policy's early years. The parent or grandparent who funds the policy can set up the policy ownership to reduce the risk that the child will become the owner before they are financially mature.

The remainder of this article will explore various ways that parents and grandparents can financially provide for minor children, young adults, and disabled individuals.

Wills and Trusts

Failure to have a Will results in your assets being disposed of according to the law of the state of your residence. Dying without a Will is known as intestacy or dying intestate. Even if your spouse survives you, intestacy could result in financial problems for both your spouse and your minor or young adult children. For example, some state intestacy laws provide that the surviving spouse receives a portion of the deceased spouse's probate estate (such as $30,000 or $50,000), and the remaining probate assets are divided equally between the surviving spouse and surviving children. This concern applies to any amount a minor or young adult receives, whether under state intestacy provisions, under the terms of a Will or trust or through a beneficiary designation.

If minor children inherit assets, a custodian (sometimes called a "guardian" or "conservator") must be appointed to hold the funds for them until the child attains the age of majority (generally age 18). Unless the funds fall below a relatively low amount set by state law, a minor child's parent is not permitted to use these funds or to act on their behalf without court approval.

The young inheriting adult, or the minor child upon attainment of age 18, could end up holding substantially more assets than they are financially mature enough to handle. As bad as this might be, it would be even worse if the surviving minor child has special needs, as the receipt of this inheritance could disqualify the child from governmental benefits and services.

The decision to purchase life insurance should be based on long-term financial goals and the need for a death benefit. Life insurance is not an appropriate vehicle for short-term savings or short-term investment strategies. While the policy allows for loans, you should know that there may be little to no cash value available for loans in the policy's early years.

[1] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty.

Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

Ideally, parents will have Wills or trusts that can help ensure that assets are left to the surviving spouses or in trust for minor or disabled children or young adults. This will avoid inadvertent transfers to immature or disabled children, and avoids the need for court-appointed custodians. If well-drafted Wills and trusts can eliminate significant inheritance issues, why do so many families leave their children unprotected? Some common reasons include:

1 | Parents cannot decide how they want their children's inheritance to be structured, or who they want to serve as trustee or guardians;

2 | Obtaining legal advice can be expensive;

3 | They don't believe they have enough assets to justify the time, effort, and cost; and

4 | These kinds of situations (where valuable assets are transferred to children) only happen to other people — "We don't know anyone who died prematurely while their children were young."

While choosing the "best" structure or the "best" person or persons to manage the children's assets can be challenging, a good structure with flexibility to make changes (such as naming new trustees) is better than intestacy or outright distributions to financially inexperienced children. If the parents and their attorney decide to use a Will, the Will can include a contingent testamentary trust to hold any assets that would otherwise be received by a minor or young adult child.

An option to consider may be the revocable trust. If a revocable trust is used, it can contain all of the primary provisions regarding how assets should be held after the death of the creator (often called the "grantor" or "settlor"). The revocable living trust can be named the beneficiary of insurance policies, retirement accounts, etc. Alternatively, an individual can name his or her spouse as primary beneficiary under the Will, and also primary beneficiary of any insurance death benefits and retirement assets, with the revocable trust or contingent testamentary trust named as the contingent beneficiary if the spouse has predeceased. This structure permits all trust assets to be within the control of the trustee after the grantor-parent's death or the surviving spouse's death. This should help protect the beneficiaries from their own financial immaturity, with the ultimate distribution postponed until the beneficiaries are more likely to be able to manage their own funds or a later date depending on the parents' objectives.

Gifts for Minors and Other Young Adults

Parents sometimes create college savings or other accounts for the benefit of their children. Grandparents and great-grandparents often desire to make gifts to or for the benefit of their grandchildren as a form of legacy planning, whether or not the grandparents have taxable estates. These gifts take many forms, but often include investment accounts or life insurance policies. One challenge in these cases is deciding who should be the owner of the account or the life insurance policy. When the gift being made is funding a life insurance policy, the grandparent would generally like to ensure that all required premiums will be paid, even if the grandparent does not survive the premium paying term or a later date, depending on the parents' objectives.

If the parent or grandparent does not want to own the policy or account themselves, common options include the use of a Uniform Transfers to Minors Act (UTMA)[2] account, a minor's trust, or an irrevocable trust.

[2] Uniform Gifts to Minor's Act (UGMA) for residents of the state of South Carolina. (All other states have the UTMA).

What are grandparents' options to ensure that policy premiums will be paid after the grandparent's death? A grandparent's Will or trust could include a special bequest to provide that a payment would be made to the policyowner equal to the remaining required policy premiums. Working with a financial advisor, the grandparent can segregate specific assets to be used to pay the premiums.

For example, assume that a grandmother is paying the premiums on a policy for the benefit of her 28-year-old grandson.[3] The grandson has two young children of his own. If he is the owner of the policy, she can use a Transfer on Death (TOD) designation so he will inherit the investment account. All policy premiums will be made from the account as gifts from the grandmother during her lifetime. After her death, the grandson can use the investment account to pay the premiums. This strategy allows her to know that her grandson will have funds to pay the premiums.

Note: If the grandmother has concerns that the grandson will not carry out her wishes, she may want to consider creating a trust as part of her estate plan to own the policies and the investment account.

Summary

Well-meaning parents and grandparents rarely consider the situations that could result in a death benefit or other large inheritance being paid directly to minor or young-adult children. This situation is made more challenging because the child is legally an adult and can make their own financial decisions before most are capable of making educated financial decisions. To help minimize situations such as Bruce's, parents and grandparents need to carefully consider not only the structure of their estate planning documents, but also the owner and beneficiary of their various financial assets and accounts.

[3] It's very important for you to understand the complex tax and ownership issues associated with this concept. You are strongly encouraged to seek advice from a lawyer who's experienced in handling trusts and estates in order to address potential issues regarding Gift Tax, Generation-skipping Tax and the proper ownership arrangements required when dealing with minors.

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