Life insurance planning for minors

In brief

LIFE INSURANCE ARRANGEMENTS FOR MINORS

Naming minors as the owners or beneficiaries of life insurance policies seems logical in many situations. For example, parents insure themselves to provide financial support for their children in the event the parents die.

- Although designating children as owners or beneficiaries seems appropriate because the proceeds will be used for the children, it poses many problems:
  - Minors are generally unable to enter into valid contracts.
  - Minors often lack the maturity, knowledge, and financial savvy required to responsibly exercise ownership rights and manage life insurance proceeds.
- Owner and beneficiary arrangements, other than direct ownership by the minor, can provide solutions to these obstacles.

Custodianships

Custodianships are created under a state's Uniform Transfers to Minors Act (UTMA) or Uniform Gifts to Minors Act (UGMA). Transfers to a minor are held and managed by a custodian under the authority of state law, which gives the custodian discretion to expend funds for the minor's benefit and invest funds on the minor's behalf. Both UTMA and UGMA custodial accounts can own life insurance policies on the minor's life or another person's life.

Trust arrangements

Transferors may give property to a minor under a trust arrangement where the trustee, as a fiduciary, is the legal owner of the property for the minor's benefit, while the minor remains the beneficial owner. The trustee has authority to hold a life insurance policy and exercise all ownership rights on the minor's behalf. A variety of trust arrangements are available:

- **§ 2503(c) Trust.** The § 2503(c) trust is named after the Internal Revenue Code provision that allows a donor (the person making the gift) to make annual exclusion gifts in trust to one minor who is under age 21. The gifts, typically cash to pay the premiums on life insurance owned by the trust, qualify for the annual exclusion without requiring a written notice and a Crummey withdrawal period according to the *Crummey v. Commissioner*[1] decision. The trustee is authorized to spend both the property and its income for the minor's benefit. The minor must receive access to the trust assets upon attaining age 21.
- **Revocable Trust.** A revocable trust generally allows the creator (or grantor) to terminate or alter the trust at any time. The grantor is allowed to maintain control over the trust assets, but trust assets are included in the grantor's estate upon death. Revocable trusts can own and manage several policies, and can have any number of beneficiaries.
- **Irrevocable Trust.** An irrevocable trust cannot be changed once the trust is executed unless the trustee or other party is provided discretion to do so. An irrevocable trust can hold a life insurance policy for a minor or on the life of a minor. The trustee manages the policy and exercises policy rights for the benefit of the minor.

CONSIDERATIONS

Which arrangement is the most suitable?

The arrangements are different, and determining the most appropriate depends upon several factors:

- ease and cost of creation,
- tax consequences,
- distribution of assets, and
- ability to provide customization.

How are the arrangements created?

- Custodianships are created by titling the asset in accordance with the applicable state UGMA or UTMA statute.
- Trusts are created by an attorney, who drafts the trust document for the grantor (often the minor's parent).

Who should supervise the arrangement?

- Selecting a custodian or trustee is an important decision. This person should be trusted, responsible, and knowledgeable.
- If estate inclusion is a concern for a parent or guardian, insured, or the donor, then that individual generally should not serve as custodian or trustee.

Who should apply for the policy?

- In general, the custodian or trustee should apply for the policy in a fiduciary capacity.
- If a trust does not exist at application, an individual with insurable interest in the insured may consider applying. If estate inclusion is a concern, the insured should not apply for the policy.

When does the minor take outright ownership of the property?

- Custodianships require distribution of property at an age dictated by state UTMA or UGMA laws, but it is often no later than age 18 or 21.
- Section 2503(c) trusts require distribution of the property (i.e., the life insurance policy) at age 21.
- Revocable and irrevocable trusts can be drafted pursuant to the grantor's wishes and provide for distributions later than age 21.

Income tax consequences

- Under UGMA or UTMA statutes, income earned on assets held by a custodian is considered the child's income (not the custodian's). This income may be subject to the "kiddie tax."
- Trusts
  - If the trust is a "grantor trust" for income tax purposes (under I.R.S. Code sections 671 – 678), the grantor bears the obligation to pay income tax on trust taxable income, which is reportable on the grantor's individual income tax return.
  - If the trust is a non-grantor trust, the trust generally pays tax at its tax rate. Trust tax brackets are compressed when compared to individuals. If the trust makes a distribution of net income, the trust beneficiary receiving the income would pay the income tax.

Summary chart

		UTMA OR UGMA	§ 2503(C) TRUST	IRREVOCABLE & REVOCABLE TRUSTS
Creation	Requires Attorney to Draft		✓	✓
	Customized		✓	✓
	By Title	✓		
Supervision	Custodian	✓		
	Trustee		✓	✓
Gifts	Qualify for Annual Exclusion	✓	✓	Revocable Trust – No Irrevocable Trust – Yes with Crummey withdrawal rights
Distributions	Mandatory at Age of Majority	✓		
	Mandatory at Age 21		✓	
	Flexible			✓

[1] Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).

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