Why Naming Adult Children as Life Insurance Policy Owners May Be Problematic

When structuring life insurance for wealth transfer, advisors often consider the use of Irrevocable Life Insurance Trusts (ILITs) to manage estate tax exposure and control the distribution of proceeds. However, some clients may suggest naming their adult children as the owners of a policy to "simplify" matters or avoid the perceived complexity and cost of establishing a trust. They may hope to bypass the initial legal fees, ongoing maintenance costs, and potential expenses associated with hiring a professional trustee. While this may seem convenient and cost-effective, it introduces significant risks and potential tax implications that could undermine the effectiveness of the client's estate plan.

1. Loss of Control and Potential for Mismanagement

When an adult child is named as the policy owner, they gain full control over the policy. This includes the ability to change beneficiaries, surrender the policy, or access the cash value. Even with the best intentions, life circumstances—like divorce, lawsuits, or financial mismanagement—can lead to decisions that conflict with the original intent of the insured. Additionally, upon the insured's death, if the death benefit is paid (1) to the adult child and their siblings, or (2) to the adult child and they distribute proceeds to siblings, those distributions may be treated as taxable gifts, creating unnecessary complications.

2. Gift Tax Consequences

Transferring ownership of a policy to an adult child can trigger immediate gift tax implications if the policy's value exceeds the annual gift tax exclusion. Additionally, any future premium payments made by the insured on behalf of the child-owner may also be considered taxable gifts. While the annual exclusion would apply, there's a limitation—only one annual exclusion can be used per gift recipient. By contrast, an ILIT can spread gifts among multiple beneficiaries, utilizing multiple annual exclusions to mitigate gift tax exposure. This structure offers more flexibility and efficiency in long-term premium funding strategies.

3. Estate Tax Exposure and Ownership Risks

If an adult child predeceases the insured, the policy ownership becomes part of the child's estate and will be distributed according to their estate plan. This can inadvertently transfer control of the policy to unintended beneficiaries, increasing the risk of mismanagement or changes to beneficiary designations. Additionally, if the child has a taxable estate, the policy adds to their estate value, further increasing estate tax exposure. An ILIT keeps the policy outside the taxable estate and ensures the policy is managed according to the original intent.

4. Divorce and Creditor Risks

If the child-owner goes through a divorce, the life insurance policy could be considered a marital asset and subject to division. This introduces the risk that the policy may be allocated to an ex-spouse or liquidated. Additionally, assets owned outright by an individual are generally subject to creditor claims. An ILIT, properly structured, offers protection from both creditor claims and family law disputes, preserving the integrity of the wealth transfer.

5. Family Conflict and Distribution Issues

When one child is the owner of a policy intended to benefit multiple heirs, disputes can arise. The owner has discretion over beneficiary designations and may unintentionally (or intentionally) create unequal distributions. An ILIT provides a neutral and legally binding structure to ensure that all intended beneficiaries are treated according to the insured's wishes.

Conclusion

While naming an adult child as the owner of a life insurance policy might seem straightforward, the long-term risks and complications often outweigh the initial simplicity. Establishing an ILIT provides a more robust and tax-efficient strategy to safeguard wealth, control distribution, and protect the interests of all intended beneficiaries.

Advisors play a crucial role in guiding clients through these complex decisions. By emphasizing the importance of structured planning, you help clients secure their legacy while avoiding potential pitfalls that could undermine their financial goals.

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