TESTAMENTARY INSURANCE TRUSTS FOR MINORS

Parents often worry about providing for minor children if they themselves should die. This is particularly the case with single parents, whose solo responsibility is a special concern. Sometimes the parents have insufficient capital to make adequate provision for their children. They may, however, be able to afford the modest outlay for insurance premiums. But if they purchase a life insurance policy for the benefit of their children, how can they control the manner in which that money will later be spent?

Where a valid designation has been made (either by Will or in the original policy), insurance proceeds are paid directly to a beneficiary upon death. However, when beneficiaries are minors they are not legally competent to receive the proceeds. When life insurance is payable to a minor and no one is authorized to give a discharge on the minor's behalf, the insurer must pay the proceeds of the policy into Court to the credit of the minor. Although an application may be made by the guardian of the minor for payment of maintenance for the child out of the funds in Court, the process is often cumbersome and expensive. Moreover, a minor has the right to demand the entire fund upon attaining the age of majority.

The simplest solution to this dilemma is for a parent to name his or her estate as the beneficiary under the life insurance policy and then set up the appropriate trust in a Will. This type of trust is called a "testamentary trust" because it takes effect upon death and guidance and direction to trustees are provided in the body of the Will itself.

The disadvantage of doing this is that the insurance proceeds will flow through the estate, increasing the costs of estate administration. Moreover, the assets of the estate must be used to pay debts before any legacies, bequests or trusts may be paid or otherwise set aside for beneficiaries. This may leave little for the children's trust. Therefore, it is often prudent to ensure that insurance proceeds *never* become part of an estate, if this can be accomplished.

The most complete method of avoiding probate taxes and the effects of bankruptcy is to set up an *inter vivos* or "living" trust (one created before a person dies), and then name that trust the beneficiary under the life insurance policy. The Trust Agreement creating the *inter vivos* trust would set out the role and responsibilities of trustees, as well as provide direction for a scheme of distribution. However, there will be initial setup fees and ongoing administration costs associated with an *inter vivos* trust, and *inter vivos* trusts do not enjoy the same tax benefits as testamentary trusts.

Caught between the lack of control inherent in an outright designation and the risk of exposure if proceeds flow through an estate, how can a parent accomplish control without putting his or her children's entitlement in jeopardy? A suggested compromise is to create a "special insurance trust" in the body of a Will. The clause creating this trust would clearly state that the insurance proceeds are *not* to form part of the individual's general estate, but rather go to named beneficiaries. The Will becomes two documents in one: because the trust will not come into existence until death, a person making this arrangement avoids the administrative costs of an *inter vivos* trust.

As a testamentary trust it also enjoys the benefit of preferred tax rates; trustees are given guidance and direction by reference to other trusts in the Will; and the insurance proceeds will not be factored into probate taxes since insurance proceeds payable to *named* beneficiaries are not included in the calculation. Ironically, however, an insurer would probably require the Will to be probated before paying the insurance proceeds as directed. To decrease the likelihood of this happening, it would be wise to ensure that the beneficiary designation in the policy itself is properly completed.

There is no complete certainty that such a trust will escape the scrutiny of an unpaid creditor in the event of bankruptcy, since there are various principles of trust law which may dictate that the constitution of such a trust would not be completely beyond reproach. Therefore, every situation would have to be separately assessed.

For those people who have purchased or are contemplating the purchase of life insurance for the benefit of their minor children, the more cautious approach would be to set up an *inter vivos* trust to ensure that if they die at least the insurance proceeds will escape their creditors. Otherwise, the special insurance trust may provide for many a practical answer to an otherwise difficult problem.