

Pitfalls of naming a minor beneficiary

Advanced Markets Q&A

Question: What happens when a minor is named as beneficiary of an annuity?

Bottom line: Certain states impose restrictions on the distribution of annuity proceeds to minor beneficiaries. These restrictions may be especially problematic for a minor beneficiary of a qualified annuity due to the required minimum distribution (RMD) rules. The restrictions are also problematic for contracts that require annuitization for a beneficiary to receive the highest value. It is typically better to name a Uniform Transfer to Minors Act (UTMA) or where applicable, a Uniform Gift to Minors Act (UGMA) account for the benefit of the minor as beneficiary rather than the minor directly. Alternatively, a trust for the benefit of the minor can be named as beneficiary.

Who is a minor? The age of majority is usually age 18 but this varies by state. Even within the same state, a child might be considered a minor for some purposes and an adult for other situations.

Example: In Minnesota, the age of majority is 18. However, if someone establishes an UTMA account, the child need not be given full access to the UTMA account until age 21.

Should a minor be named outright as beneficiary of an annuity? This depends very much on state law but it can create very unhappy clients and producers!

Why? In certain states, an insurance company is not permitted to distribute funds over a nominal amount (typically \$5,000 or \$10,000) to a minor without having the parents obtain court documents proving that they have been appointed as guardian of the minor's estate. Parents may not understand the difference between being a guardian for the child's care and being a guardian of the minor's estate, and may believe they have both guardian rights automatically as a parent. The bigger problem is that sometimes the parents must post a bond so that the court can make sure that the minor will be reimbursed if the parents misuse the annuity proceeds.

Example: Timmy is 15 years old and lives in Virginia. Grandpa recently died and Timmy is the named beneficiary of Grandpa's \$50,000 Allianz or Allianz Life of NY annuity.

Under Virginia law, Allianz or Allianz Life of NY can distribute \$10,000 to Timmy. To distribute the other \$40,000, Virginia law requires Timmy's parents to obtain a certificate of qualification as Guardian of Timmy's estate from the local probate court. Timmy's parents have to post a bond in order to receive the certificate. They would also have to file an initial inventory with the court and an annual report until Timmy reaches age 18.

The simple solution? The unnecessary paperwork and expense could have been easily avoided simply by naming an UTMA account for the benefit of Timmy as beneficiary of the annuity rather than naming Timmy outright as beneficiary.

Note: If you name an UTMA account as beneficiary, you also should specifically name a custodian for the UTMA to manage the account until Timmy reaches the UTMA age of majority. Let's assume that Grandpa wants to name Timmy's mother Mary as custodian. He would complete the beneficiary designation as follows: "Mary Smith, as custodian for Timmy Smith under the (state's name) Uniform Transfer to Minors Act:"

Another alternative is creating a trust for Timmy's benefit and naming the trust as beneficiary rather than naming Timmy directly as beneficiary.

Uniform Transfer to Minors Act and annuities

Advanced Markets Q&A

Question: Should a minor own an annuity?

Bottom line: Having a minor as owner of an annuity can be problematic. If it is determined that having a minor own an annuity is suitable, it may be better to name a Uniform Transfer to Minors Act (UTMA) or UGMA account as owner of the annuity rather than the minor directly. Alternatively, a trust for the benefit of the minor can be named as annuity owner.

Who is a minor? The age of majority is usually 18 but this varies by state. Even within the same state, a child might be considered a minor for some purposes and an adult for other situations.

Example: Grandpa transfers \$15,000 to an UTMA account for Timmy in 2016. Grandpa will need to file a gift tax return reporting the gift by April 18, 2017.

Example: In Minnesota, the age of majority is 18. However, if someone establishes an UTMA account, the child need not be given full access to the UTMA account until age 21.

Can a minor own an Allianz or Allianz Life of NY annuity?

Why is it better to have an UTMA account own the annuity for the benefit of the minor? For one thing, an UTMA account can be set up for a minor of any age. Only older minors (typically, age 15 or 16 – depending on the state) are able to own the annuity outright.

Yes. If a particular state honors contracts made by a minor of a certain age (often this is 15 or 16), we do permit a minor of the specified age to own an annuity.

An UTMA account also gives the parent (or other donor) more control over the gifted monies. The donor either serves as custodian of the UTMA account or selects a custodian to

What is a Uniform Transfer to Minors Act (UTMA) account? A Uniform Transfer to Minors Act (UTMA) account is a custodial arrangement for the benefit of a minor (Timmy). An irrevocable gift is made to the UTMA account and a custodian is appointed to manage the account until Timmy reaches the UTMA age of majority. When Timmy attains the age of majority, the custodian steps down and Timmy becomes the owner of the UTMA account (and the annuity).

manage the UTMA account until Timmy reaches the UTMA age of majority (which is usually age 21 or older). Until Timmy reaches the UTMA age of majority, the custodian can make distributions to Timmy as the custodian deems advisable for Timmy's benefit. At the UTMA age of majority, the UTMA account (and the annuity) belongs to Timmy.

Gift tax return reminder: If you transfer more than the federal gift tax exclusion amount (\$14,000 in 2016) to an UTMA account in any particular year, you will need to file a gift tax return by April 15 of the year following the year of the gift.

Important: Keep in mind that if Timmy is under age 59½, a 10% federal additional tax is going to apply to any taxable distribution (with a nonqualified annuity, this would be any increase on the contract) in addition to income tax and any surrender penalties. Thus, if the intent is to use the annuity for Timmy's college costs, an annuity may not be the most appropriate funding vehicle for the UTMA.

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Is the UTMA age of majority different from the regular age of majority? Remember that under a particular state's law, the age of majority for UTMA purposes may be different from the age of majority for other purposes.

Can you take an UTMA gift back? No. Any money or other asset transferred to an UTMA account is an irrevocable gift. It belongs to the minor. If UTMA funds are used for any purpose other than for Timmy's benefit, Timmy can later sue the custodian for misuse of the funds.

How should an UTMA-owned annuity be structured?

A typical UTMA-owned annuity might be structured as follows:

Owner: John Smith as Custodian FBO Timothy Smith under the (state's name) Uniform Transfer to Minors Act

Tax ID#: Timmy's Social Security number

Annuitant: Timothy Smith

Beneficiary: Will depend on state law – typically this should be the child's estate. In most states, if the child dies before reaching the UTMA age of majority, the child's estate is distributed to the child's children, if any. If the child does not have children, the child's estate is typically distributed to the child's parents in equal shares or all to the survivors of them. Keep in mind that if the child's estate is named as beneficiary of a nonqualified annuity, the annuity will have to be distributed to the estate within five years of the child's death. A probate court proceeding may also be required before the annuity proceeds can be distributed.

What if my clients don't want the minor to have access to the UTMA account at the age of majority? With an UTMA account, ownership of the UTMA account must be transferred to the minor when the minor attains the UTMA age of majority. If the donor wishes to retain control over the funds beyond the point at which the minor attains the UTMA age of majority, the donor may wish to establish a trust for the benefit of the minor and have the trust own the annuity rather than using an UTMA account as owner.

Reminder: Another drawback of naming a young person as the owner of an annuity (whether outright or through an UTMA designation) is the kiddie tax. This taxes the child's unearned income in excess of the \$2,100 exemption (in 2016) at the parent's highest rate. A "kiddie" is anyone up to age 18, or ages 19-23 if a full-time student. In all cases, the kiddie tax only applies if the child does not provide more than half of their support. Other requirements must be met for the kiddie tax to apply.