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Deciding if Your Kid Is Trust-Worthy

Parenting is more than reading to your children or getting them to eat their vegetables. It's also about securing their financial future. One way to do that is by drafting a trust and naming a trustee. In this excerpt from her new book "The Wall Street Journal Financial Guidebook for New Parents," Stacey L. Bradford explains why parents may want to consider estate-planning tools beyond a will.

You don't need to be Bill Gates to consider setting up a trust for your kids.

Even middle-class folks can benefit from trusts when it comes to estate planning. That's because children under the age of 18 can't directly inherit more than a small amount of money. If you have more than that to leave to your minor child and make no provisions in your will, a court will appoint a property guardian to manage your child's assets until he reaches 18 or 21, depending on the state.

That property guardian may be a complete stranger who won't understand your values. Perhaps more important, the guardian could add one more layer of bureaucracy to an already complicated situation. When your child needs money, the guardian may have to make a formal request that then goes through the court system. It can be a real headache for your kids to get funds when they need it, and it's not an arrangement that's always in their best interests.

One way around the court system is to set up a custodial account for your kids through your will. In that case, you get to name the custodian, and he decides how the money is spent. Once your son or daughter is legally considered an adult, he or she inherits the money outright. The problem with this setup is that your kid might blow through the money and have nothing left over for college or grad school.

For many parents, setting up a trust is a better alternative that allows them more control over how their money is spent once they're gone. If you have the means and want your child to go to private school, for example, include that in the trust document. A trust can also delay the age at which your kids get their hands on the money.

This is often the biggest selling point for parents. Most people, looking back, would probably agree that they didn't necessarily make the most responsible decisions about money when they were 18 or 21, a time of life when it may have seemed perfectly reasonable to rack up credit-card debt. Even delaying a few more years -- until, say, 25 -- makes the money more likely to be put toward, for example, education or a down payment on a house.

While setting up a trust is a bit more complicated than a custodial account -- it requires a lawyer's assistance, for one thing -- it also provides more financial security for your children and is therefore worth considering. Ideally, you should set up a trust when you draft your will. But you can always add a trust later as your estate gets more complicated or your assets grow. For most parents, a simple trust will do. For more advanced planning purposes, such as reducing estate taxes, you could consider other options, such as a marital bypass trust or a grantor-retained annuity trust.

Here are a few questions to ask yourself to determine if a trust is right for your family:

Do you anticipate leaving your children more than a modest sum of money?

A trust may not be worth the effort if you think you'll only be leaving a child (or children) $100,000 or less. On the other hand, if you're leaving life insurance money to cover four years of school and you own a home, there's a good chance a trust would make sense for you.

Do you want to have some say in how your children's money is spent?

A trust allows you to restrict spending to basic support, including food, clothing, education and health care. This is something that can't be done with a custodial account. If the custodian is a soft touch, he could end up lavishing your child with designer jeans and a fancy car, leaving very little left for the college years. Even worse, if the custodian is also the guardian, he could start writing himself large "support" checks to help cover his other expenses.

Would you prefer that your children not inherit the money when they turn 18 or 21?

If you think giving a high-school senior a large sum of cash is a recipe for disaster, then you should consider a trust. The ability to delay inheritance was the main draw for drafting a trust for Laurie and Greg Wetzel, a New York City couple in their mid-30s with three small children. Should something happen to both of them, they decided, their kids will each receive half of their inheritance at age 30, and the remaining amount when they reach 35.

"Your 20s are such a transitional time that we don't want our children to have significant financial decisions to make," Ms. Wetzel says.

Do you want the money to be used for a college education?

If you specifically bought life insurance so that there would be enough money to help fund college in the event of your death, then you'll definitely want to delay the age at which your kids inherit your money. Otherwise, your child could think a red Ferrari is a better investment than a crimson Harvard diploma.

Would you like your children to have recourse if their money is mismanaged?

One more benefit of a trust that you don't get with a custodial account is that a trust is a legal contract; the trustee has an obligation to follow your directions and act in a reasonable and prudent manner. If the beneficiary feels the trustee spent the money frivolously, he can demand an accounting, and can sue for reimbursement if the trustee acted improperly with the funds. It may be pretty tough to prove illegal or improper actions with a trust, but just the threat of a possible lawsuit can keep someone in line.

Choosing a trustee. The trustee holds the purse strings, so don't delegate this job lightly. You need someone who is trustworthy, is good with money and has great attention to detail. In other words, don't choose your brother who has trouble remembering to pay his own bills.

Your trustee is going to be working with your guardian, so they had better get along. While they don't need to be best friends -- in fact, it's probably better if they aren't -- they also can't be archenemies. You want your trustee to be able to tell your guardian she can't use the money to buy your son a new sports car, but you also want your trustee to take your guardian's phone calls when she needs more money to pay for your son's braces.

Then there's the issue of naming a family member as your trustee. There's no general rule here, and many people prefer to name a sibling since there's no one in the world they trust more. Siblings also typically don't charge to perform the service. On the other hand, my husband and I chose a close family friend. In our case, we felt he would be less biased and more likely to follow through with our wishes without passing judgment on how we want our child's money spent.

You'll also face the debate over naming your children's guardian as the trustee. On one hand, it's rather convenient. The person raising your kids won't have to ask anyone for permission about how the money will be spent. But a division of power can be a safer route. Some estate-planning attorneys worry that having one person fill the dual role leads to a conflict of interest and the risk that the guardian could take money for herself.

If you have a lot of money -- more than a million dollars -- you may want to name a bank or a lawyer to act as trustee. An institution has a lot of experience handling accounts and taking care of all the investments and necessary tax paperwork. You could also offer your trustee the option to hire a bank and act as co-trustee or as an agent, so that he or she still has ultimate control. He or she would basically keep an eye on the bank. Just be aware that a bank's services aren't free. They typically charge an annual fee of 1% to 2% of the principal.

Drafting the trust. Now that you've gotten this far, it's time to hire a lawyer, or use the same one who drafted your will. An attorney may ask you to sign standard forms, but don't feel locked in; you can personalize the trust to better meet your family's needs.

As much as trusts are about maintaining some say in how your money is spent, the language in the document should be vague enough to allow your trustee some leeway should your child's needs change or should something come up that you couldn't have anticipated.

Finally, you'll want to write your trustee a letter expressing your wishes for how you want the money spent on your children. Some parents go so far as to say that some of the money can be used to help raise the living standard of the other kids they may be living with, so everyone feels equal. Of course, it's up to the trustee to crunch the numbers and make sure there is still money left over to meet your main goals.

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