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5 Ways NOT to Gift to Children … and 5 Better Ideas

Parents who mean well sometimes put their children in a position to blow it.

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Giving to children can be a weakness. We often want to help children actualize their financial goals and give them an easier life than we might have had. However, gifting to children can also be a disaster: We all realize that many children are irresponsible with money, do not have enough life experiences yet to protect it, and are targets of those interested in getting a piece of the money you gave them.

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Here are five common and less-than-ideal gifting scenarios, and suggestions you can use to protect your assets:

1. Gifting a Child a Highly Appreciated Asset

Capital gains taxes elicit less attention than income and estate taxes because they are usually assessed at a lower percentage (15% or 20% for capital gains taxes vs. 40% for estate taxes). However, if you gift assets during your life, capital gains are the taxes that require the most vigilance to avoid.

If I gift my children my old shares of ABC company stock, which I bought for $10 a share and now sells for $100 a share, my child also receives my cost basis, meaning they have a $90 per share capital gain they owe taxes on.

The Better Idea: Gift cash or stock that has minimal appreciation. If I bequeath the stock after I pass away, the cost basis is "stepped up" to the value of the stock on the date of my death, meaning they now have a $100 cost basis per share and no capital gain if they sell it immediately. Therefore, you should hold onto highly appreciated stock and bequeath it after your passing so its cost basis "steps up" upon your death.

2. Naming Children as Joint Owners on Real Estate

In many parts of the country home prices have skyrocketed: For too many children the notion of ever becoming a homeowner without some help from family members is impossible. However, the issue that caused the problem in the first place (expensive housing) now snowballs, because Mom and Dad not only have to help with a down payment, they also have to name themselves on the mortgage.

There are additional issues that arise for different people buying real estate with their children: More wealthy individuals may be depleting their gift tax exemptions and not know it, children with their own college-age kids may be hurting their financial aid opportunities if the real estate is a second residence, and younger children with uncertain job opportunities may rely on Bank of Mom & Dad to pay mortgage and real estate taxes for a long time.

The Better Idea: Carefully consider the consequences of future real estate expenses and co-signing a mortgage with your child. Lay out expectations, and have a back-up plan of your own if your child cannot find stable income to fulfill his side of the bargain.

3. Naming Children as a Joint Account Owner Without Documenting the Transfer

Joint accounts are a gifting topic that is multi-dimensional: Something that looks so easy is actually really complicated! First, there are the problems regarding basis that we've already discussed. Next, when wills are contested, many times there are questions about whether the account is "with rights of survivorship," meaning it passes to your beneficiary when you die, or a "convenience account" made solely so the child can pay your expenses for your convenience, then passing by your will after you die. And worst of all, if either person has a creditor issue the funds may be open to attack.

Having a child named as an attorney in fact under a power of attorney should allow her to access your funds for convenience purposes. Having a beneficiary named as a transfer on death beneficiary should clear up any issues regarding your intended future recipient of the funds, avoid them becoming probate assets after your death, and protect them from your child's creditors while you are alive.

The Better Idea: Minimize joint accounts and ask your children about their outstanding debts. If the funds are for your needs, have your child named as a power of attorney on the account; if they are for the child's benefit it is better to name the child as the account's beneficiary or gift them directly during your life.

4. Naming Minor Children as Beneficiaries

Minor children cannot own financial assets without an adult being named as a co-owner, conservator, custodian or some other fiduciary position. When payment of a significant life insurance policy, retirement plan or transfer on death account is triggered by the passing of the account owner, the courts hold a legal proceeding to name an adult to oversee the money until the child reaches the age of majority (usually 18, depending on what state). But what happens if at that point, say, Johnnie gets the urge to buy his fraternity house and bankroll his very own entourage?

Many people rarely review or update their beneficiary designation forms on retirement plans and life insurance policies. Certain events, such as divorce or death of a primary beneficiary, mean the minor child (usually the contingent beneficiary) is now the unexpected recipient of funds that he and his family can't access without court supervision. You also lose the ability to have the funds held-back until the child reaches an age or responsibility or, even worse, have funds transferred to a disabled beneficiary and disqualify them from government programs such as Medicaid.

The Better Idea: Designate a trust that benefits the minor as the beneficiary; have it name a trustworthy person as trustee, and have provisions that protect from the beneficiary's youthful indiscretions, creditors and disabilities.

5. Gifting Outright to Children in Unstable Marriages

People in puppy love tend to make bad long-term financial decisions (such as rejecting advice to draft a prenuptial agreement). After marriage, they make even worse financial decisions when they sense marital troubles on the horizon (overcompensating, or commingling non-marital assets with marital assets to try to smooth things over).

Parents should protect their adult children from the indiscretions of courts and future ex-in-laws by ensuring gifts and bequests are kept in separate accounts that are never mixed with the child's marital income and assets. Instructing a family member to act as a trustee in order to make trust distributions into segregated accounts for the beneficiary and mandating a no-nonsense discussion with an estate attorney should help inform the child of the financial perils that often materialize after a divorce.

The Better Idea: Set the expectation that a prenuptial agreement will be signed, and that you will pay for your child's legal representation. If one does not exist, create a trust and consider making sure it does not give the child a "power of appointment" over the trust funds.

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