



## **Should Savings Be In The Child's Name Or Not?**

This is one of the most frequently asked, and one of the most frequently misunderstood questions in all of taxes. That's because it involves three separate decision-making areas: income tax decisions, estate tax decisions, and financial control choices.

First, let's review ways you can save on behalf of a minor in 2000.

There are three main ways:

- 1) In a custodial account for the minor;
- 2) In a trust, or
- 3) In your name.

Each has its own advantages and disadvantages. However, they all share a common denominator which is the attempt to shift income and assets in a most favorable way for income tax and estate tax purposes. How old the child is, how much savings is at stake, how long the savings plan will be in effect, and how much you trust the minor when the age of majority is reached are critical factors in deciding how title should be set up.

### **Using A Custodial Account**

In order to have the savings legally in a minor's name so you do not have any income tax consequences of your own, it can be done through the Uniform Gifts To Minors Act (UGMA), or the latest version, the Uniform Transfer To Minors Act (UTMA). Basically, these two methods involve gifting over money to the child, and appointing a custodian to manage the funds (the custodian can be any adult including yourself). These accounts are easy to set up with any bank, brokerage company, money manager, or the like. The child's social security number must be used since the money is legally the child's the minute it goes into the account, and taxable to the child.

There are a few differences between the UGMA and the UTMA that should be noted. A UGMA account automatically gives control of the funds to the child at the age of 18 while a UTMA account can delay this until age 21, or in some states even age 25. The UTMA has more savings options in that the custodian can buy real estate, and royalty producing investments to name a few.

However, not all states allow the newer UTMA's, although the trend is moving toward it. As of 1992, there were 27 states allowing this more liberal custodial account:

Alabama, Arkansas, Colorado, California, Florida, Hawaii, Illinois, Idaho, Iowa, Kentucky, Kansas, Louisiana, Massachusetts, Minnesota, Missouri, Montana, New Hampshire, Nevada, New Jersey, North Dakota, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, West Virginia, and Wyoming.



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## **ADVANTAGES OF USING A CUSTODIAL ACCOUNT**

If donors appoint someone other than themselves as custodian, the funds may escape any of the donor's potential estate taxes and/or any lawsuits. Also, the income generated by these savings is taxable in the minor's name, which can result in significant savings if the bracket for the donor is higher than the child's bracket. This is usually the case, except when the "kiddie tax" kicks in at certain ages (we will discuss this shortly). Another positive is that it is very easy to set up, with no fees, no lawyers required. The yearly tax return required is a regular income tax return so tax filing can be quite simple and inexpensive.

## **DISADVANTAGES OF USING A CUSTODIAL ACCOUNT**

One of the main complications from an income tax standpoint is the "Kiddie tax" problem. This was part of the 1986 TEFRA (Tax Reform Act). In effect, it said that the tax rate a child would pay on taxable "unearned income" from savings depended on two things: the age of the child, and the amount of the taxable income. Under IRS 2000 rules, if the child is under age 14, and this taxable income is over \$1,400 in round numbers, the child pays a tax at a rate the same as the parents' on all the income exceeding this \$1,400 figure. In effect, the Kiddie tax law makes some custodial accounts much less attractive since there now exist situations where there is no longer any tax savings from parent to child above these levels compared to the old laws. It makes planning much more difficult as well because one must be able to project out the yearly taxable income and coordinate it with the child's age in order to maximize the tax savings.

The game plan now is to have \$1,400 or less in unearned income until the child reaches 14 to minimize taxes, then do an about face—maximize the taxable income after that age (when the Kiddie tax rules no longer apply). As you can see, much more attention must be placed on the type of investments used, the projected yields, the child's age, and the tax bracket differentials between parents and child because of this set of tax laws.

Another disadvantage to custodial accounts is that the money is legally the child's from the time you gift it; when the child reaches the age of majority, the child can do whatever is wished with it— even buy a Harley Davidson—and there is nothing you can do legally to stop this. So you should have a good sense of trust in the child's future judgment when you set up a custodial account.

## **Trusts**

There are several trusts you can set up, but the most common for this purpose would be the 2503(c) trust, nicknamed the "minors' trust." This is complicated to set up, and can be expensive, usually requiring a lawyer. Also, the yearly tax return that must be filed (Form 1041) can be quite involved, and expensive to have prepared.

However, it may have certain advantages. First, the trustee can control the money much better—and longer if it is handled right. In effect, it can be structured so that the trust can continue long after the child reaches age 21, thus keeping control of the principal on behalf of the donor. Second, under the revised 2000 tax codes, the tax rates may be more predictable on the first \$7,500 of taxable income from the trust regardless of the child's age—unlike a UGMA or UTMA account, so it is easier to plan the tax consequences and types of investments. Third, the money in the trust can be shielded from the donor's creditors in event of a lawsuit. Finally, it allows for more sophisticated estate tax planning avenues.



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## **Your Own Name**

Saving in your own name is a viable choice as well. Although the tax savings may be less if your tax bracket is higher than your child's, you retain full control of the funds. When the time comes to use the money for the child—usually for education—you can gift over the money in time payments. As long as you make sure the annual gift amount is \$10,000 (adjusted annually for inflation) or less per person (a husband and wife can jointly give \$20,000), you have no gift/estate taxes to worry about. Also, you can make direct payment to the educational facility (instead of giving it to the child) without any dollar amount restrictions for gift tax laws.

The disadvantages are twofold. First, the money is considered part of your estate, so at death, it may be subject to estate taxes. Second, since the probability is that your tax bracket is higher than your child's you may pay more taxes (especially after the child reaches age 14) with the same type of investments if they are in your name vs a trust or custodial account.

Of course, a way to get around the higher tax problem is to use investments that don't produce ordinary taxable income. Naturally, you should go over these possibilities with an investment or financial advisor. Some of these alternate investments are: growth-type investments that appreciate in value instead of paying interest or dividends (stocks, real estate, etc.); tax exempt bonds; tax deferred bonds like Series EE Savings Bonds; certain tax deferred annuities; and company sponsored pre-tax savings plans.

In effect, you can minimize—or optimize—your income tax bracket yet still retain control and ownership of the investments.

## **Bottom Line**

Using a trust makes sense if the investment in question will be generating a relatively large enough amount of taxable income before the minor is age 14 to justify the extra costs of setting it up, and doing the yearly Fiduciary Income Tax Returns. Also, the spread between the parents' tax bracket and the trust's must be sufficient enough to justify it as well. But if you are a typically average parent saving a typically average amount for your child, the probability is that this 2503(c) trust would not be the first choice from an income tax saving standpoint.

As you can see, each option carries with it strengths and weaknesses. However, the more you feel you can trust your children, the higher your tax bracket, and the better you can predict the taxable yields on the investments used, the more favorable a Custodial Account could be. But if you cannot adequately guarantee they will use the money for its intended purpose when they reach the age of majority, think twice about using a Custodial Account!