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Investing in Children

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Investing for children is no longer a game for the rich.

Parents of all incomes can invest money in ways that will pay for future education or other things while reducing current income taxes.

Because the $4,825 average cost of one year of public college is expected to triple in the next 10 years, it is best to start saving as soon as an infant is born.

Ten years ago, investing for children was done only by the wealthy. Today's proliferation of investments, especially pooled investments, brings this type of investing within reach of every person," said David L. Biehl, partner in the financial planning firm of Bailard, Biehl & Kaiser.

"The pooling vehicles take the management decisions away from the investor and leaves them to professionals . . . this gives the regular person more confidence to go out and invest," Biehl said.

Inflation is another motivation to invest when children are young.

"There is a greater awareness today about how much kids cost," Biehl said. "The large inflationary period taught people to plan now for baby or they won't be able to catch up. In the last five years, there has been a dramatic increase in investments for children."

Investing for kids, however, isn't child's play.

Tax pitfalls and differences loom between parents on how much risk to take. Parents also must face at least two other uncomfortable thoughts — what if they divorce or if poor investment decisions later prompt their children to sue them.

Rarely has a child sued a parent for mishandling fiduciary responsibilities. But marriages split up before children tap an investment and parents often differ on money management.

"Two different people, even if they are happily married, have different ways of looking at risk," said J. Richard Braugh, vice president and resident manager of E.F. Hutton & Company Inc. "If one tugs one way and one tugs the another, you have a disaster in the making."

A stockbroker, financial planner or lawyer specializing in taxes and estates can mediate a couple's different approaches to investing. Typically, they advise designing a diversified portfolio for long-term growth that gives the parents the flexibility to use the money in an emergency.

Besides saving money for a child's future, one of the main benefits of investing for children is shifting the parents income from their higher income-tax bracket to their children's lower bracket.

Suppose parents, who jointly earn $110,000 yearly and are in the 50 percent tax bracket, invest $260 a month in a real-estate-investment trust. The trust earns 10 percent per year, but after taxes the net yield amounts to only 5 percent. At the end of 10 years, the parents would have $40,372.

If the $260 was first given to a child, the money in the same real-estate-investment trust could earn 10 percent after taxes. Because the child is in a zero-tax bracket, after 10 years $53,136, or 32 percent more, would be saved.

Christine Cox / Seattle Times

Different kinds of trusts are the "legal wrappers" that can shelter the parents' income from taxation.

The Uniform Gift to Minors Act is a simple custodial account parents can have arranged by a financial planner or stockbroker without expensive legal fees. Any type of property can be given as a tax-free gift, including real estate, securities or cash, up to $10,000 per child each year. The account requires the signature of only one parent.

The drawback to this type of account is that by law a child takes control of the fund at the age of 18.

"That's when they are hot-blooded and parents don't want them to control it," said Braugh.

To keep tighter control of investment assets, parents can choose a "reversionary" or temporary trust. Commonly known as a "Clifford trust," this legal wrapper is in effect for a minimum of 10 years. When it's dissolved, the investments revert back to the parents.

"The pitfall is that a Clifford trust is considered an irrevocable living trust and therefore cannot be changed," said Owen G. Fiore, taxation attorney with the firm of Hopkins, Mitchell & Carley.

He advises parents to hire a tax specialist who knows the nuances of Clifford trusts because there isn't any way of undoing a lawyer's mistakes once the trust is established.

Legal fees for arranging this kind of trust cost roughly $1,000.

"You can't revoke an irrevocable trust just because it doesn't meet what you thought were the tax benefits," Fiore said.

A common mistake parents make, he said, is funneling quickly appreciating stock, such as securities in a start-up high-technology company, into a Clifford trust. The danger occurs if the trust sells this stock and gets a capital gain. Because the Clifford trust is a type where the ownership of the principal reverts back to the parents, this capital gain is treated as principal for income-tax purposes, Fiore said. Parents would have to pay income taxes in the year the gain is received.

To get around the capital-gain problem, parents could put investments in a non-reversionary trust, a type where the principal is owned by the beneficiaries and never reverts back to the parents. The capital gain in this case is taxed to the trust or the children, not the parents.

Because they are in a lower tax bracket, children or the trust would pay less income tax than the parents. Parents can choose the length of time before children have access to the money in a non-reversionary trust.

"If you can handle giving it, once it is gone it will not in the future cause any further estate tax (to be assessed against inheritors) and it will save income taxes," Fiore said.

A popular device is to arrange for an irrevocable trust and give to the trust a gift of, say $10,000, then lend the trust a much bigger sum at no interest, Fiore said.

The advantage of the arrangement, commonly

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