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Should I save for college in
my name or my child's
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Question:

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Answer:

There are three potential drawbacks to saving in your child's name--the kiddie tax, federal financial aid rules, and control issues.

First, the kiddie tax. At one time, saving money in a child's name was recommended because of the tax saving opportunities that resulted when children were taxed at their own rate. However, Congress partially closed this loophole some years ago with passage of special rules commonly referred to as the "kiddie tax." The kiddie tax makes a child's unearned investment income over a certain amount subject to tax at the parents' tax rate. For 2009, this amount is \$1,900 (the first \$950 is tax free and the next \$950 is taxed at the child's rate). The kiddie tax rules significantly reduce the tax savings potential of a child holding assets in his or her name.

The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support. To lessen the impact of the kiddie tax, choose tax-free or tax-deferred investments in which the annual expected income does not exceed the threshold amount of \$1,900 (in 2009).

Second, the federal financial aid rules have a more negative impact on child assets than parent assets. Under the current federal aid formula, a child must contribute 20 percent of his or her assets to college costs each year, whereas parents must contribute 5.6 percent of their assets each year. So \$10,000 in your child's bank account would equal a \$2,000 contribution from your child, but that same \$10,000 in your bank account would equal a \$560 contribution from you.

The more assets a child has, the more he or she will be expected to contribute to college costs, and the less financial aid he or she will receive, because the financial need is less. However, keep in mind that obtaining less financial aid is not necessarily a bad thing. The average financial aid package consists mostly of loans, so by paying more up front, chances are you or your child will just incur less debt, as opposed to losing grants and scholarships (which do not have to be repaid).

Finally, there is the control issue. Many parents open a custodial account for their child (UGMA or UTMA) to save for college. However, when the child reaches the age of majority (18 or 21, depending on the state), he or she gets full control over the money in the account and can use the money for anything--college, or perhaps a backpacking trip to Europe. Some parents aren't willing to relinquish this control to their child.

For all these reasons, it's generally recommended that parents save for college in their own names, not their children's names.

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