# 177: 4 Ways to Save and Invest for Your Kids


## Full Episode Transcript

**With Your Host**

## Bonnie Koo, MD

# 177: 4 Ways to Save and Invest for Your Kids

Welcome to the *Wealthy Mom MD Podcast*, a podcast for women physicians who want to learn how to live a wealthy life. In this podcast you will learn how to make money work for you, how you can have more of it, and learn the tools to empower you to live a life on purpose. Get ready to up-level your money and your life. I'm your host, Dr. Bonnie Koo.

Hey, everyone, welcome to another episode. I am back from almost a month of traveling. I was in Paris for 10 days. And as soon as I came back we, the family, went away for about five days. We went up to Boston, visited my sister-in-law and some friends who live up there. And now, I guess I'm getting ready for my son to start kindergarten, which is in a few weeks.

And I will tell you, before I had kids when I would hear about parents feeling nervous about kindergarten, I'd be like, really? It's only kindergarten. And now that I'm a parent, I get it. And anyone who's listening who's a parent, I think we can all relate that we thought we were better parents before we were parents. It's kind of funny and ironic. But anyway, that's where we are.

So yes, I am feeling nervous and excited. We enrolled Jack in a totally different type of school. It's an outdoor program. I've had to buy all this gear that I never even heard of. I'm not even talking about going to REI, like brands that I've literally never heard of.

And it makes sense that there are clothing lines specifically for kids who are outdoors every day, because obviously they're going to go through a lot of wear and tear. And so it's been interesting and expensive.

And so I've been looking for hand-me-downs because I don't really want to pay that much, considering I'm going to have to get multiple rain pants for Jack because we might lose some and some might just get beyond repair, right? So that's what's going on over here.

All right, so today I wanted to, speaking of kids, talk a bit about what's available for your kids in terms of saving and investing money for them. So the big caveat here is that do not do this at the expense of your own financial life or retirement. Meaning, so here's the thing, many of the clients

I work with are thinking about this mainly in the context of paying for college.

And I think it's a wonderful gift to be able to pay for your kids' college and maybe even graduate school. But please do not do this at the expense of your financial independence because there's a saying, and it's true, they can always take out loans for school, there is no such thing as a retirement loan, okay?

So again, this is a nice to have, a wonderful thing to do for your kids. And again, do not do this at the expense of your own retirement. Okay, now that said, I do some of these things and so I'll tell you a bit about my experience and sort of the ease around doing it. So I'm going to go over four different ways to do this.

So the first thing is opening up a regular brokerage account for your kids. Now, many of you listening probably have a regular taxable brokerage account for yourself. And in case you're not sure what that means, it just means a regular account where you invest in stocks, et cetera that's not inside a tax protected account like a 401K or 403B or a Roth IRA or regular IRA.

So you can do this for your kids. Now, they have different names because they're basically a custodial account, meaning that you are the custodian. You have full control over the account until your child becomes of age. It's not necessarily 18, it actually depends on the state. So some states it's like 21, sometimes it's 22, it just depends. But let's just use 21 as an example, and you'll have to look up the rules for each state.

Now, the account has an acronym. It can be called a UTMA or a UGMA, and that's state specific but they're basically the same thing. It stands for, actually I forget. Something like a uniform trust minors account, but basically a brokerage account for kids.

Now, I have one for Jack and ours is at TD Ameritrade, you can open it wherever you want. And so the common custodians, when I say custodian this time, that means in the context of like the bank, right, is TD Ameritrade.

Although at the time of this recording, actually, it's probably going to be Charles Schwab. Charles Schwab bought TD Ameritrade and I keep getting notifications to open my Charles Schwab account because it's all getting transferred there.

So let's just say Charles Schwab, Vanguard, Fidelity, I'm pretty sure they all allow you to do this. So you just open an account, it's pretty simple. Enter a few things, enter their information, their meaning the kid. And what I've been doing is I haven't really been contributing much of my own money. Maybe a little bit, I can't remember, Jack is almost six now.

But whenever he gets money gifts, and grandparents tend to be, at least ours are pretty generous with their birthday gifts. So I just literally just directly deposited that money into his account. And what's great is I can literally do a mobile check deposit like you can for your regular checking account. So I've just been doing that and investing it on Jack's behalf.

Again, when he becomes of age, let's say 21, he gets full control over it legally. I guess technically you can just tell them they don't have it, but I don't know why you would do that. So that's what we have for him. That's number one.

The second thing you could do is the typical sort of college accounts you may have heard of, 529s. And there's something called a Coverdell ESA as well, I'm going to talk about both of them. So these are tax protected accounts. I want you to think about them as a Roth IRA specifically for education and related qualified expenses.

I probably should have talked about the Roth IRA first since I'm comparing this to a Roth IRA, but that's okay. So, a Roth IRA is you put after tax money in and then it grows tax free. And then when you take out the money, it's tax free. So you only pay taxes on the money once, your earned income.

Okay, so a 529 and Coverdell ESA is basically a Roth IRA for education. So you contribute money to your 529, I'll explain more about what I mean by what these accounts are. You invest it, typically there's pretty much a limited list of funds. And hopefully 10, 20 years later you have a nice sizable amount there and then you can withdraw the money to pay for your kid's college.

Now, 529 plans are state specific. And what I mean by that is, let's say you're like, okay, I want to open up a 529 for my kid, how do I open one? You don't just go to Charles Schwab or TD Ameritrade like I was mentioning before, you open up one through a state. It does not have to be the one in your state, which I know can be confusing. Like, okay, why does every state have one?

It's because some states will give you a little bit of a tax break if you open one, but each state has different rules. So, for example, this may have changed because this information is a few years old, but you just look at the rules for your state.

So when I lived in Pennsylvania for a minute, they also offered a tax deduction, it was very minor, like in the scheme of things it's like you're saving 300 bucks, right? But still, hey, $300 in taxes you don't have to pay, all the better, right?

They allowed you to use any state 529. But some states will say we will only give you the tax deduction if you use our state 529, okay? Now, every state has different types of funds you can invest in. So if you live in a state that does not give a tax break, or you live in a state with no income tax so it doesn't matter anyway, then I would say here are the sort of top most popular 529s, and I'll tell you why in a second.

So the New York one is pretty popular, Nevada and Utah. And the reason why is that – So New York, that's actually where Jack's 529 is. They invest in Vanguard funds and the expense ratios for the funds are pretty low.

Nevada also uses Vanguard, and at the time of this recording at least, when you open one through Nevada, it actually will show up on your Vanguard account. So if you already have Vanguard accounts, like for example I have a brokerage and a Roth IRA at Vanguard, when I log into that I will see the 529 there. Versus with Jack, even though they're invested with Vanguard funds, I have to log into the specific New York 529 account.

Now, Utah is popular because I believe they also offer Vanguard but they also offer access to, and I can't remember, the name escapes me, but certain funds that otherwise are only available through a financial advisor. I believe the name is called dimensional funds, but I don't want you to get too confused or overwhelmed about which state to use.

So here's the algorithm that I'm going to recommend to really simplify this process for you. So, first of all, look up does your state offer a state income tax deduction? If the answer is yes, what are the rules? Do you have to use that state's plan? If the answer is yes, then use that state's plan. Simple, right?

Okay, if you do get a state income tax deduction but they don't care where you have it, then your choices are New York, Utah or Nevada. If you already have Vanguard accounts in your name, just open the Nevada one. I'm all for simplicity and it's simpler if that account is just automatically on your Vanguard dashboard, right? It's one less account to log into.

And if you don't have a Vanguard account, then just pick. Just do literally eeny, meeny, miney moe. It really doesn't matter, okay?

Now, if your state does not offer a state income tax deduction, I would, again, pick one of those three, Utah, Nevada, New York. Again, it doesn't matter. Just literally pick one, it doesn't matter. Okay, so that's sort of the algorithm for that.

Now, what is a Coverdell ESA? So the Coverdell ESA, or ESA for short, I think it stands for educational savings account. It was around before 529s were invented and it's basically similar, but the contribution limits are very, very low.

Now, I wasn't even going to mention a Coverdell ESA because there's really no point in opening one because of some recent changes with the

529, but I just wanted to mention it for completeness. But very low contributions, like 2 or $3,000 a year. There are income limits.

So I just want to mention it just so I covered everything, but I would just say forget about it. Now, I have one for Jack, we don't contribute to it any longer. I'm not even going to talk about it now.

Back to the 529. Now, 529s are very attractive because, like I said, you put money in, it grows tax free and as long as you withdraw it for a qualified educational institution and qualified expenses, it is withdrawn tax free. And so that's very attractive, right? So if you start a 529 very early, it has 18 plus years to grow, right?

And here's a fun fact, you can actually open one before they're born, it would just be in your name as if you're opening your own 529. So if you're someone who really likes to plan ahead, if you're listening and you don't have kids but you know you're going to, you can open one in your name. I actually did that, I think a year before Jack was born I think because New York gave a tax deduction. And the taxes in New York are so high, so I was like, why not? It wasn't a lot, but I opened one.

And here's what I want to say about what if your child does not go to college, right, because then you have all this money socked away. Because that's a question that I get a lot.

Number one is you can change the name of the beneficiary. So let's say your kid ends up not going to college or for some reason it is not used, you can give it to a niece or another family member, or literally anyone. So that's an option. So basically, you're gifting it to somebody else.

You could also use it. Now, I'm not suggesting you're going to go back to college or grad school just to use it, but there are some interesting institutions where you can use it at. Let me give you a few examples.

So there's actually a website where you can search eligible institutions. But just a quick search here, like you can go to culinary school, for example, if you wanted to learn how to cook. And there are some study abroad programs.

And your kid may not go to college, but you might be having him go to private school, like K through 12. Now, you can use it for that. I would say when Jack was born, that actually wasn't the case. They just added that pretty recently. But most people would advise against doing that because then the money is not going to really grow, right? And so it doesn't really make sense to put after tax money and use it for K.

I'm not saying that you should never use it for private, like a secondary school. But maybe wait until they're in high school, right? I think that just makes sense.

Now, what are the contribution limits for a 529? Now, the contribution limits are basically the gift tax limit. And for 2023, the limit is $17,000. Now, many people get really confused about the gift tax, and it makes sense because, first of all, the name makes it sound like the recipient pays a tax. But that's actually not true.

I have a whole podcast episode on that, episode 22. So we will link that in the show notes. But if you have a podcast app, just search for gift tax and you will find the podcast episode. I don't want to spend too much time on it. But basically, the annual contribution limit for a 529 is the gift tax limit of $17,000.

Now, there's a special law, or provision rather, that you can actually front load a 529 five years at a time. So 17,000 times five. So that comes out to $85,000. Now, even better, if you're married you and your spouse can actually both do that. So you could potentially pop in $170,000.

Now, if you are in a place where you can do this, amazing. But if you're not, don't worry about it. But let's just say as soon as your child is born, you front load that account with $170,000 and let it grow for, let's just say 18 years. In fact, I'm going to just do a quick calculation here just to illustrate how much it could be.

And what I'm doing here is just using a simple compound interest calculator. And I made some assumptions. I basically said years to grow 18. The interest rate of 10% compound interest. Now that's going to grow to some obscene amount, like a million dollars, and obviously you probably hopefully do not need that for your child's education. And again, this is going to be for, I guess, K through 12, college and graduate school.

So actually, potentially, if your kid goes to private school through graduate school, you could potentially be spending a million dollars. But most of us probably aren't going to do that.

Now, this special rule where, again, I said you can front load five years of the gift tax limit, so at the time of this podcast in 2023 the gift tax limit is $17,000, times five. Now, what that also means is that you can't contribute again to the 529 for another five years. But you probably wouldn't want to. Plus there are actual contribution limits.

And so this is a state by state thing, so some states won't let you contribute beyond, let's say 200k. But they typically range between around 200 to 500k in terms of contributions, which means the money you put in, not the total amount in the account. Most parents I know that contribute to 529s have not front loaded, or maybe they just front loaded a little and they make annual contributions here or there.

The great thing about 529s is that you can have family members also contribute. So grandparents, uncles and aunts, that could be a great way for them to gift money to the child. Jack gets invited to birthday parties, I have not seen any parent give out this link, like, hey, we would appreciate a contribution to the 529, but I guess you could do that too, technically.

And I believe there are a few credit cards where, I think it might be Fidelity, whatever you charge, there's a cashback that goes into the 529. But I don't recommend that because I think credit card points are way more valuable.

Okay, let me just summarize because I know I threw a lot of information at you just now. Okay, I want you to think about a 529 plan, an educational account for your kid, as a Roth IRA for your child. You put taxed money in, it grows tax-free. And when you withdraw it to use for qualified educational expenses, tuition and there's some other things on the list, and it has to be at a qualified institution that the IRS recognizes, then you can withdraw it tax-free.

And if you contribute early on, like when your child is born, especially if you front load it, it can grow to a very sizable amount by the time you need it for college. You can use it for private school K through 12, but generally speaking, I probably wouldn't recommend doing this because then you're just drawing on the money that could grow for college. And let's just face it, college expenses are insane. Like totally insane.

I can't even imagine what it's going to cost for Jack. When I went to medical school, and I went to a private school, I went to Columbia, the tuition was $40,000 for medical school. College tuitions are insane now. Actually, I was having lunch with a friend and she told me that her kid's private school college is $80,000 of tuition a year. To me, that's insane. I don't even think Columbia is at that amount right now.

But I do think we're going to have a little reckoning, hopefully a big reckoning with the amount colleges pay. I think it's crazy. And so I just can't imagine it's going to keep increasing. It's obviously increasing way faster than inflation, like there has to be a cap at some point, right? Because the way it's going now, by the time Jack goes to college tuition is going to be like $500,000 a year, which, who can afford that?

Okay, now let's move on to a Roth IRA. Now, your child can have his or her own Roth IRA. Now, just like a regular Roth IRA like you might have, your child needs to have earned income, okay? And earned income is not chores, like a real job, okay?

So they could be babysitting. They could be mowing other people's lawns. If you have a business, you can employ them, but it has to be for legit work. You can't pay them like $500 an hour to clean your office, right? That's just not what you would pay a normal cleaning person, right?

And I think the litmus test is like, would you pay someone else that amount of money for the job your kid is doing? And if the answer is no, then you're probably overpaying them, okay?

Now, I also have a podcast episode on Roth IRAs and anything with the name Roth in it, because there's Roth 401Ks and Roth conversions, and I have found that it's very confusing. And so podcast episode 14, so one of the earlier podcasts, it's from 2020. Listen to that and you will understand all things Roth.

Back to a custodial or kids Roth IRA. So, again, most of you with kids, this will probably not apply until, let's say high school, because that's usually when kids get a job if they get a job, right? And so babysitting or, like I said, mowing lawns or shoveling snow, or maybe they get a job at the local bookstore.

When I was in high school I worked at a bookstore and at a pharmacy and at a library. Not all at the same time. The library I do remember paid me $4 an hour. I think the pharmacy paid me 6 or $8 an hour. And the bookstore I can't remember. But anyway, all those earnings can go into a custodial Roth IRA.

And just like a regular Roth IRA, you can't contribute beyond the earned income. So let's say your child makes $2,000 during the summer for whatever work they're doing. Let's say Jack ends up doing that, he's six so clearly he's not mowing lawns. But let's say when he's 16 he mows lawns and he makes $2,000 a summer, which is probably a lot but let's just roll with it.

That means the max that he could contribute to his Roth IRA is $2,000, right? He can't go beyond $2,000. Now, here's something I want you to consider, because if your child is making $2,000, I'm pretty sure they are not going to want to put that whole $2,000 in their Roth IRA, right?

Kids are working so that they have some spending money, right, to go to the movies, to hang out with their friends, et cetera. But money is fungible, so you can just contribute the $2,000 for them, and they can keep the $2,000 for spending money.

Basically, what I mean is that it doesn't really matter where the money comes from, but the earned income has to be legit and it has to stay, or rather if it's $2,000 like the example I just gave for Jack mowing lawns, you can't contribute more than $2,000, okay?

Now, it's up to you how you want to do it, but I'd probably recommend that they have some skin in the game, right? Because I think this is such a great teaching opportunity of compound interest and finances and all that stuff, right? So maybe it's something like, hey, if you put 25% of your earnings into the Roth IRA, I will pop in the rest. So that means you're doing 75%. I'm just thinking out loud, but I think that's probably what I would do with my son, you want them to have some skin in the game.

Of course, you could just do it for them. No judgment, it doesn't really matter. But I just think as a teaching opportunity it would be, I think, just a good habit for them to just assume that they should always be investing a portion of their earned income. And again, you can open this anywhere that allows you to open up a custodial Roth IRA. Vanguard does it for sure.

Now, the last thing I want to talk about is this, and this is more in the context of paying for college but, obviously, it's applicable for lots of other things. So let's say your kid is in college and college is stupid expensive. Let's just say you're spending $50,000, just to make the numbers nice and round, a year in tuition.

Now, obviously, if you're cash flowing that, meaning you're paying it directly out of your income or whatever, savings, your money is going to be taxed at a much higher rate. Most of you listening are high income earners, you might even be in the top tax bracket. And so if you are, you're paying quite a high percentage on your taxes.

Now, you have to remember the federal tax brackets are graduated, and so this is a common misconception. And so the tax brackets, let me just look this up real quick because they change every year. So it starts at 10%, and tops off at 37%. But if you're at the 37% tax bracket, which is an income of close to 600k or more, that doesn't mean all of your money is taxed at 37%.

Now, that's a common misconception. Only part of your income is taxed at 37%. But let's just say for the purposes of this illustration, your percentage tax is, I'm just going to say 40% because that's a blend of federal and state, okay?

Let me just backtrack a bit because I'm probably confusing everyone. Let's just say you make a crap ton of money and you are paying 40% taxes on your income between federal and state. I know it's a tragedy when that happens, right? Okay, so that means for every dollar you make, you get 60 cents, okay?

So contrast that with your kid. Let's say your kid makes 30k a year. Now, not only that, but you're paying your child $30,000 a year salary for working in your business. Now, this is really powerful and here's why, your business pays your child $30,000, which is a deduction on your business, right? And then that $30,000 is income for your child. But since they only make $30,000, they're paying a lot less in taxes, okay?

And so that top tax bracket for federal is 12%. Let's just say it's 15% for federal and state, versus your 40% in the illustration I just gave you that you're paying. And what that basically means is your child gets to keep a lot more of that money in taxes versus if you made that same $30,000, right? Because your $30,000 is part of you making multiple hundreds.

And so this is a, I don't want to say fancy, but this is a way to save on taxes and use that money to pay for your kid's college with money that has been taxed significantly less than the money that you would contribute directly.

Of course, you have to have a legit job for your child. But I know many of my clients, you know, if you own your own practice or you own your own business like I do, this is something you can definitely do and think about for the future.

All right, so those are the four different things I wanted to talk about today regarding putting money away for your child. Of course, there are other ways to do this, like if you own a real estate business you can buy them real estate in their name, you can teach them about it. I think that's actually a wonderful way to teach your kids how to create wealth, get them involved in your real estate portfolio when they're older and they can understand the terms more.

And I definitely know some parents who buy their child a home for college and then the child, or I guess they're an adult when they're in college, they can have roommates and that money from the roommates can pay for the mortgage. So there's so many ways to do that if you own real estate and business.

Okay, so let me just summarize what I just went over. The first thing I went over is opening a brokerage account for them, called a UTMA or UGMA. And it's like a regular brokerage account and you can contribute, family can contribute, whatever you want to do for that.

The second thing I talked about was an educational account, like a 529. And I want you to think about it as a Roth IRA for education. You can use it for K through 12, but my recommendation would be to wait until at least high school if you're doing private school or just wait for college that way you have almost two decades, or at least a decade of compound interest working.

And you also have the ability to front load it to about $170,000 when the kid is born. Most of us probably won't do that, but it's nice to know that you can front load it if you need to or if you want to, rather.

Okay, the third thing I talked about was opening a custodial Roth IRA for your child. This requires earned income. So if your child is making money babysitting, mowing lawns, or maybe even working inside your business and they get paid a legit income, they can contribute up to the amount that they earned as long as it's not beyond the Roth IRA contribution limit, which is usually around, at this time around $6,500.

And then, obviously, they can invest that. Or rather you'll invest that money for them, and a great way for them to put money away. Can you imagine, think about it, if your child starts contributing to a Roth IRA at age 15, I mean, we're talking several, several decades of compound interest. Insane, right?

The last thing I talked about was paying your child, adult child a salary, like 20 or $30,000 a year to work for your business, maybe you own a practice. And use that money to pay for college because that money is taxed significantly less than your tax bracket.

All right, I hope this was very helpful. And hopefully maybe you will open up some type of account for them. All right, I'll talk to you next week.

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