TAXES

What's the Best Way to Spend Your Child Tax Credit Money? Financial Advisors Share 3 Tips.

By Andrew Keshner, MarketWatch   July 13, 2021 4:56 pm ET

Evgeniy Parilov/Dreamstime

This article originally appeared on MarketWatch.

What will *you* do when you get it?

Some 39 million households, accounting for almost 90% of U.S. families, will receive the enhanced Child Tax Credit starting this week. The Internal Revenue Service will issue the payments the middle of every month, from July 15 to December 15.

Eligible parents with kids under age six will get up to $300 per month per child while parents with kids ages 6 to 17 will receive up to $250 per month per child.

Millions of parents will view the money as a critical financial lifeline. The money could potentially cut child poverty in the U.S. in half when combined with other federal cash assistance, some researchers say.

But just like the government's previous Covid-related stimulus payments, some parents will regard the payments as a windfall that they're happy to have, but that they don't need to pay basic expenses.

This is a "good problem to have," says Seth Mullikin, principal at Lattice Financial in Charlotte, N.C.

Mullikin and other financial advisors say the Child Tax Credit money can be put toward savings and investment moves to help kids pay for college—or even their retirement. The money could also provide your child's first crash course in financial literacy, advisors said.

The Child Tax Credit has been around for decades, but President Joe Biden's $1.9 trillion American Rescue Plan made some significant changes for one year only. It increased the credit from $2,000 per child to $3,600 for children under age 6, and $3,000 for kids ages 6 to 17.

The CTC was previously paid as a lump sum, layered onto a person's income-tax refund. This year, half of the total amount will paid as an advance in monthly installments for qualifying families.

The income limits to receive the full payments are the same as they were for stimulus check money. The thresholds are $75,000 a year for individuals, $150,000 a year for married couples filing jointly, and $112,500 a year for people such as single parents who file as head of household. The IRS uses income data from either 2019 or 2020 tax returns.

529 plans are a great place to start

The college savings tools known as 529 accounts are a great place to start for families looking for places to deposit extra CTC cash, said Catherine Valega of Green Bee Advisory in Boston, Mass. Families can withdraw money from a 529 account without paying federal and state income taxes on it in most states, as long as the funds go toward qualified higher education expenses including tuition, books and laptops.

A student with a scholarship can still use the money for other expenses like room and board. If the intended beneficiary doesn't go to college, the money can be rolled over to another person in their family.

Like 401(k) accounts, 529 accounts are defined-contribution plans tied to market performance. How the money is invested depends on the account holder's risk tolerance and the number of years before college starts.

Many plans offer age-based investment options that grow increasingly conservative as the beneficiary nears college. Risk-based investments, regardless of the beneficiary's age, are another option.

The earnings inside the tax-advantaged 529 plans will not be taxed by the IRS, nor by state tax authorities, according to H&R Block (ticker: HRB). Contributions to a 529 plan are not deductible in federal taxes.

Even a little helps. If the parents of a one-year-old child deposit $3,600 into a 529 plan, with a 6% annual return and no further contributions, that money will grow to $10,275 by the time the child is age 18, Mullikin said.

By the end of 2020, there were almost 15 million 529 college savings accounts, according to the College Savings Plans Network, an organization offering information to states running college savings plans.

These accounts contain more than $425 billion in assets and the average balance was $28,679 by the end of the year, the organization said.

Retirement accounts? Yes, really

There are various types of custodial accounts—accounts that parents establish when their children are minors—but Valega and Mullikin say a custodial Roth IRA is a good option for the enhanced Child Tax Credit payments.

Traditional IRAs contain pre-tax dollars, so the money is taxed when withdrawn. But the money in Roth IRAs is post-tax, so it can be withdrawn tax-free decades from now. What should you do with CTC cash? Valega says, "Let's do a Roth."

Not only does it give an individual the obvious advantage of getting a head start on saving for retirement, but owning such an account can put retirement on your child's radar and kickstart their retirement planning.

Another added benefit: they provide financial literacy crash course. Would you like your child to wow his or her classmates with the latest on subjects like IRAs, taxes and compound interest? "You are going to be light years ahead of all your peers in terms of financial literacy," Valega said.

There are caveats. As MarketWatch's Tax Guy Bill Bischoff explains: "When funds are transferred into a minor child's custodial account at a financial institution or brokerage firm, the funds now irrevocably belong to that child."

The current maximum annual contribution for a custodial account is $6,000, or the the maximum of a child's earned income for the year—whether it's babysitting or gardening—whichever amount is less, according to Fidelity Investments.

If a child just makes $2,000 from a summer job, $2,000 is the contribution limit. The money does not need to come directly from the child's wallet, Mullikin noted. Parents, for instance, may decide to match their kid's income with contributions.

Other types of custodial accounts include brokerage accounts, but Valega said parents and kids need to be careful. A custodial brokerage account is technically the child's asset, and they oversee it when they are no longer a minor.

Federal financial aid formulas consider 20% of the money in custodial accounts to be available for college bills. Roth IRAs are not deemed an asset by federal financial aid formulas when assessing parents' ability to pay for their children's college fees, Valega said.

Set up an estate plan

Some parents should consider opting out of the CTC cash, experts say, because the advanced payments are subject to income eligibility rules.

If the IRS determines that the CTC has been overpaid to a family based on their 2021 income, it will either deduct the overpayment from the household's refund next tax season or tack the sum onto the tax bill.

If you already have a 529 plan and/or custodial account for your children, consider using the CTC money to set up a will and/or a living will for healthcare decisions, said Gregory Giardino, a financial advisor at J.M. Franklin & Company, based in Tarrytown, N.Y.

Wills can dictate inheritances, who serves as a guardian for a child and a trustee for an estate. Related documents can state who serves as power of attorney. Such documents are "invaluable in protecting your children," he said.

But many Americans overlook the process. Two-thirds of Americans in one December survey said they didn't have a will and media reports are dotted with stories of wealthy celebrities who have died without wills.

Attorneys can charge between $150 and $600 to draft a will, according to LegalZoom. The cost might range up to $1,000, according to AARP, formerly the American Association of Retired Persons.

"It can create more control and direction over your wealth, should the unexpected occur," Giardino said. After 16 months of a global public-health crisis, many parents might be able to relate to that.

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