WEALTH MANAGEMENT

How To Save Efficiently For A US/UK Child

As the UK is approaching the three-year anniversary of the first Covid-19 lockdown, many studies exploring the impact of the pandemic have begun to emerge.

In one particularly interesting study[1], data from the Human Fertility Database showed that in January 2021, European birth rates declined by 14.1% and, although followed by a rebound of births in subsequent months, this rebound did not compensate for the initial decline.

Despite this drop in birth rates, a common question we receive from clients pertains to investing for US/UK children in a tax-efficient manner.

As the parent of a dual US/UK child myself, I am all too aware of the pitfalls of trying to save for your child in a tax-efficient manner all while juggling the nursery run!

Fortunately, there are US and UK products both which can be tax-efficient and can allow parents to save for their children's future.

Is My Child American?

A child born outside of the United States to a US citizen parent could inherit US citizenship upon birth. The US Department of State website includes a useful overview of circumstances where a child will acquire US citizenship however, as always, professional advice should be sought as the regulations are nuanced.

As an aside, it is not uncommon to be told by a long-term UK resident, US citizen, that they have yet to 'decide whether to make their child American' (I have always found such wording amusing - wondering if this means watching baseball, teaching them to enjoy Cheez Whiz and ensuring they say sidewalk instead of pavement). On a serious note, this is not a decision one can make as the answer will be objective and based on the appropriate US regulation. If a child meets the criteria, they will be a US citizen.

Should one's child inherit US citizenship, it is important to report the birth to a US embassy or consulate and apply for a Social Security number. When reporting your child's birth abroad, a US citizen parent will need to account for all days spent outside of the UK since birth to satisfy a residency requirement! Get out those old passports now.

Investing On Behalf Of A US Citizen Child, Resident In The UK

As a sleep deprived new parent who has just navigated the reams of paperwork for a dual citizenship baby, the next sensible step is, of course, financial planning!

Although there are favourable investment products for children in the UK (in particular, Junior ISAs, Lifetime ISAs and Junior Self-Invested Personal Pensions (SIPP)), it is important to remember that the main investment principles for Americans abroad remain - beware of Passive Foreign Investment Companies (PFICs) and remember US reporting requirements.

So, whilst a Junior ISA may seem like a great idea, the IRS does not recognise the tax-free nature of an ISA and would seek to tax the underlying investments. Additionally, most collective investments within a Junior ISA are likely to be considered PFICs from a US perspective and taxed punitively.

US Investment Products For Children

Thought must also be given to the way in which the UK will treat US investment products. Two common investment products in the US for children are 529 plans and accounts established under the Uniform Transfers to Minors Act (UTMA) and the Uniform Gifts to Minors Act (UGMA).

529 plans allow for tax-free growth provided funds are used for education savings

529 Plans

529 plans allow for tax-free growth provided funds are used for education savings. Generally, any US citizen or resident alien is eligible to participate in a 529 and plans are commonly established by parents or grandparents.

Contributions

Contributions to a 529 plan are made from after-tax dollars that then grow tax-free. In certain cases, state income tax deductions may also apply.

Contribution limits to a 529 plan vary by state however, the maximum contributions currently allowed are substantial (over $300,000 per beneficiary in many state plans).

Contributions to 529 plans are gifts under the federal gift tax regulations. Therefore, if an individual contributes more than $16,000 per year (2022 limit) (there is also the ability to 'front load' five years' worth of contributions), the contribution will count against the individual's lifetime gifting allowance for US tax purposes.

Distributions

Distributions from 529 plans for qualified higher education expenses are exempt from US federal income tax. Qualified education expenses include tuition, fees, books, supplies and equipment required for study at any accredited college, university or vocational school in the United States and many foreign universities. In some circumstances, the money can also be used for room and board.

Should a non-qualifying distribution from a 529 be made, it is subject to federal income tax and an additional 10% early-distribution penalty on the gains earned above the original contributions.

Assets held in a 529 plan are excluded from the donor's gross estate for estate tax purposes. Additionally, 529 plans are treated as an asset of the account owner as opposed to the beneficiary which could lessen the impact on a student's eligibility for financial aid.

Lastly, should there be an excess in a beneficiary's 529 plan, these amounts could be transferred to other members of the beneficiary's family without incurring any tax penalty.

UK Taxation

From a UK perspective, many consider 529 plans to be foreign trusts. Given the complexities surrounding trusts, it is, as always, important to seek tax advice in the first instance. However, if structured correctly, 529s can be dual US/UK tax efficient.

UTMAs/UGMAs

UTMAs and UGMAs also allow individuals to make an irrevocable gift to minors. Funds within an UTMA or UGMA are taxable and can be withdrawn for any purpose, not just education.

Contributions

There are no contribution limits for deposits into an UTMA or UGMA. However, like 529s, contributions to UTMA and UGMA plans are gifts under the federal gift tax regulations. Therefore, the donor who is funding the accounts is subject to their own annual gift tax and lifetime estate tax exclusions.

Distributions

Withdrawals can be made for any expense that benefits the minor and there are no penalties for withdrawal. Unlike 529 plans, the balance of any UTMA or UGMA would count towards any financial aid calculations in the United States.

Once the minor beneficiary reaches majority age (typically 18 or 21, but in some instances, 25), the assets become the legal property of the beneficiary.

US/UK Taxation

UTMAs and UGMAs are taxable on the beneficiary. Every child younger than age 19 (or age 24 should the child also be in full-time education) is allowed a small amount of unearned income (up to $2,300 in 2022) taxed at a lower rate. Unearned income above $2,300 would be subject to 'Kiddie Tax' and would be taxed at the parents' marginal income tax rate, which currently could be as high as 37%. It should be noted that the $2,300 exemption is per child, not per account.

Like a 529 account, the UK treatment of UTMAs and UGMAs is not straightforward. UTMAs are commonly considered bare trusts for UK purposes, with the legal owner being subject to UK income and capital gains tax. Additionally, it is possible that the UTMAs will need to be registered under HMRC's Trust Registration Service (TRS). The TRS is HMRC's way of tracking onshore and offshore trusts.

Junior SIPP

Unlike 529s or UTMAs/UGMAs, a Junior SIPP is a UK product. While not for education purposes, a Junior SIPP does allow for long term savings for a child.

Contributions

Anyone can pay into a Junior SIPP and a parent or legal guardian normally manages the account until the child turns 18.

When funds are added to the SIPP, the government automatically adds 20% in pension tax relief. The maximum contributed each tax year is currently £2,880, with the government adding up to £720 on top.

Distributions

Like most pensions, money in a Junior SIPP is free from UK income and capital gains tax until distributions are taken.

A Junior SIPP cannot be accessed until the child reaches the minimum UK retirement age (age 57 from 2028 with a further rise likely in the future). Distribution rules are the same as a normal adult SIPP with testing against the lifetime allowance at crystallisation and once the SIPP is crystallised, the owner can take the 25% tax-free lump sum. Once in drawdown, withdrawals can be taken at any point. Tax and financial advice should be sought prior to pension distributions to ensure the most US/UK efficient drawdown methods.

UK/US Taxation

A Junior SIPP is a qualified UK pension and taxed as such with income tax payable on distributions from the pension.

The position is not as clear cut from a US perspective, and, in some circumstances, a Junior SIPP would be treated as a foreign grantor trust and require the filing of a Form 3520 and possibly Form 3520-A or other US forms.

It is a common refrain, but given the complexities, US/UK tax and investment advice should be sought to better understand the status of a Junior SIPP.

As can be seen, when structured correctly, it is possible to save for a US/UK child in a tax-efficient manner and the benefits of starting early are profound

Summary

As can be seen, when structured correctly, it is possible to save for a US/UK child in a tax-efficient manner and the benefits of starting early are profound.

For example, assuming one makes a maximum contribution into a Junior SIPP and growth averages 4% per annum (net of all fees) – by the child's 18th birthday the pension will be worth around £96,000. If no further contributions are made and the pension continues to grow at 4%, the pension would be worth over £606,000 by the time the child reaches 65!

Reference:

1. https://academic.oup.com/humrep/advancearticle/doi/10.1093/humrep/deac215/6759684?searchresult=1

Stephen Johnson
Stephen.Johnson@masecopw.com