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Ready for School

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Don't forget income shifting and gifting when helping affluent clients plan their kids' education funding

Other than their homes, your clients' largest lifetime expense may be paying for their children's or grandchildren's education. Annual tuition at private schools can range from $5,000 to $25,000 for up to 12 years, and college and graduate school can easily be a multiple of this amount. Total expenses to educate one child in this fashion from first grade through college can easily top $250,000. Most individuals and families pay these expenses with after-tax money, meaning that they must earn another 35% or so to gain the necessary funds to pay for school (or incur student loans). However, there are a number of ways to pay for some or all of a child's educational expenses in a tax-advantaged fashion. Using these techniques can shave your clients' total tax bill by at least a third in some cases. Moreover, counseling clients to use these techniques also adds some rather visible additional value to your advisory services.

So what are these techniques? You may have your clients consider income shifting and tuition reimbursement accounts as primary methods to lower the cost of education. We'll also discuss the use of various tax credits when the child reaches college and graduate school age. We will leave it to others, however, to review the methods of using after-tax money for education costs, such as the Coverdell IRA and Section 529 plans.
The concept of income shifting is based on the fact that almost all children have a lower tax bracket than their parents for both earned and unearned income. Most of your clients have income from interest, wages, and some dividends taxed at a 35% rate, and capital gains—and some dividends—taxed as high as 15% to 20%. However, the tax rates of your clients' children are likely to be between zero and 10% in all categories of earned and unearned income, if they are over age 14.

There are two ways to shift income to children. The first, and the most powerful, can be used primarily by families or individuals who control a business, whether it's a traditional business or even a home-based "second" job. The second method involves gifting investments that have increased in value. The children may then sell these gifts and pay for the gains at their lower tax rates.

Once a child reaches college age, there are educational tax credits available that can markedly reduce or eliminate any tax burden resulting from income shifting.

Shifting via a Business & Gifting
A child can earn income by working in a business even at a young age. Clear records should be kept of the time worked and the complexity of the work, and the child's salary should be appropriate to his age and hours worked. All payments for work are tax deductible as ordinary expenses to the business. If the parents' business is incorporated, then Social Security and Medicare taxes may be due on the amounts paid to the child, though under Federal tax law, if the business is run as a sole proprietorship or spousal partnership, then no such taxes are due.

Any individual of any age may earn up to $4,850 per year without any income tax due to the standard deduction, independent of any unearned income received. Annual income of between $4,850 and $7,300 yearly is currently taxed at 10%, and from $7,300-$29,700 at 15%. All these brackets are significantly lower than the bracket for wage income earned by the parent. If a child receives earned income, then she will need to file her own tax return, rather than being part of her parents' return. If the child is paid more than the tax-allowable amounts, then it would be prudent to pay estimated taxes as well. State and local income taxes may be due in some locations, and Social Security taxes are due on wages paid by a corporation.

The business owner can pay an older child up to $8,850 per year, with the amount appropriate to the child's age and job responsibilities. The child can open a traditional IRA and fund it with $4,000 per year. This lowers her earned income back to the untaxed $4,850 level. The money in the IRA can be left to grow tax-free until age 70, or can be withdrawn for educational costs during college and graduate school. If such a withdrawal is made, tax will be due on the entire amount withdrawn, but the young person will probably be in a low tax bracket during those years. Penalties for early withdrawal of IRA savings are waived if the money is used for educational costs. If the child is young and has income of less than $4,850, then a Roth IRA might be appropriate.

An even more aggressive but perfectly legal approach is to pay an older child up to $14,850 (the limit as of 2005) and have the child contribute to a SIMPLE IRA set up by the family business; a tax-deductible $10,000 contribution is allowed. Note that the business is not permitted to run another qualified plan at the same time. Remember, unearned income up to $1,600 per year for a child under age 14 is taxed at a blended rate of 5% or less; above this amount, the unearned income is taxed at the parent's bracket. Once the child reaches age 14, unearned income is added to earned funds to determine his taxable income.

When the child reaches college age, tax credits can be used to minimize or eliminate taxation due to the student's earned income.

If a child's parents have investments that have appreciated and subsequently sell them, they will pay ordinary income tax—35% in most cases—on those investments if they have been held for less than one year. Longer-term investments will be taxed at lower rates—as low as 15% in certain cases. If parents instead gift appreciated investments to a child, then the child can sell the asset and pay tax in a lower bracket. Income shifting by gifting may also lower the parents' adjusted gross income (AGI), which may allow more eligibility for otherwise-phased-out tax breaks. A parental asset held more than one year can be gifted to the child and immediately sold without losing the long-term status, as gifted assets retain the donor's basis and holding period. Each parent may gift each child up to $11,000 of assets or cash per year without any gift tax consequences.

For a child under age 14, the first $800 in unearned income goes untaxed, and the next $800 is taxed at 10%. After $1,600, the tax is imputed at the parents' rate. However, once the child reaches age 14, the tax is imputed at the child's own rate as noted above, which is almost always significantly less than the rate of the parent. It therefore pays to have a child receive unearned income of up to $1,600 per year under age 14, and higher amounts at later ages. The income can come from the sale of gifted assets or from income generated by funds held in a custodial (UTMA) account. If a child's total income is less than $30,000, placing him in the 10% or 15% income tax bracket, then long-term capital gains taxes on the child's sale of investments is in the 5% bracket.

In certain cases, a family limited partnership or a limited liability company can be used to shift income to children, without the parents losing control of the underlying assets. This method of transferring income may be preferable to the irrevocable gifting when making contributions to a UTMA account. Other methods that give parents some continued control of gifted assets include a minor's trust, an irrevocable trust with Crummey powers, and a 529 plan.

I encourage clients to fund custodial accounts as early as possible in their child's life to take advantage of these facts. A significant amount of gifted assets, such as growth stocks, may not produce much unearned income. These investments can be shifted to those that produce more income, or sold when the child is over age 14. Parents should also gift income-producing assets to a child over 14 in order to take advantage of the child's lower tax bracket. Remember that funds transferred into a UTMA account are legally owned by the child.

Tuition Reimbursement

A Section 127 tuition reimbursement plan may be offered by your business to benefit a child who is attending either college or graduate school. Under such a plan, your business may reimburse tuition and book expenses up to $5,250 per year and deduct it as a cost of business. It is not reported as income to the student, although the student cannot be a dependent on your tax return. This is yet another reason for children to declare themselves financially independent as they enter college. The Section 127 plan—which must not discriminate toward highly compensated employees—can be an excellent idea for a small family business.

When children reach their college years, it is usually advantageous to have them declare themselves independent in terms of financial support. The parents do lose the ability to use the child's personal exemption of $3,100, but this benefit has usually been phased out already if the parents have substantial income. Even if the personal exemption has not been phased out, it often pays for the child to be independent for three reasons: The Hope

Learning Credit, the Lifetime Learning Credit, and the aforementioned Section 127 plans.

The rule for being independent of the parents is that the child must have more than 50% of her yearly expenses paid from her own assets. This money can come from custodial accounts, earned income, withdrawal of IRA money, or even from money gifted to the child by parents or grandparents each year in school. Once the child is independent, he or she may file for the Hope Learning Tax Credit of $1,500 per year for the first two years of college. Note that this is a tax credit, not a deduction, and can be used as long as the child's income is less than $41,000. Using this credit usually results in the child having little or no tax liability.

For instance, a child with $20,000 per year in income during the first two years of college could use her personal exemption ($3,100) and standard deduction ($4,850) to lower her estimated taxes due to about $1,800. The Hope credit could be applied, and the young adult would pay $300 in tax on $20,000 in income.

An alternative to the Hope for students with high tuitions is the Lifetime Learning Credit, which can be used throughout college and graduate school, and is equal to 20% of the first $10,000 in tuition paid each year. Therefore, a credit of up to $2,000 per year can be applied against any income tax due. This credit is better than the Hope for the first two years of school if tuition is over $7,500 per year, and is the only credit available after the first two years of college. The student cannot be a dependent of her parents, and only one Lifetime Learning Credit can be used per year per family.

To conclude, these methods are meant to suggest areas for an advisor to explore with the client's tax professionals, and not as specific advice for an individual client. Using pre-tax and low-tax-bracket funds not only will help pay for a child's education costs, but will also add value to your relationship with clients.

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