



FINANCIAL PLANNING

Income-shifting Strategies Involving Your Children

By Steve Williams, CPA

Children bestow many blessings on our lives, but they are rarely viewed as financial assets. However, there are ways to structure your finances around your children that can benefit the whole family.

If you are the parent of a minor, you may already know about certain tax breaks that you can utilize, such as the child tax credit and the child and dependent care credit. However, you might have overlooked another tax break involving your children—ie, shifting income from your own tax base to that of your child. Three key ways to do this include contributing to a Section 529 college savings plan, hiring your children, and transferring income-producing assets. All of these strategies will help to reduce your family's overall tax burden.

SECTION 529 COLLEGE SAVINGS PLANS

Section 529 of the US Internal Revenue Code specifies requirements for college savings plans to be free from federal income taxes. The tax advantages of Section 529 plans are that any earnings grow tax-deferred, and distributions for qualified higher-education expenses are free

from federal income taxes. Thus, rather than putting money into a certificate of deposit (CD) or taxable brokerage account for your child's college education, you can save it in a tax-free Section 529 account.

Savings from Section 529 plans can be used for tuition, books, supplies, and equipment required for enrollment or attendance at an eligible institution of higher education. Qualified institutions include most accredited 2-year and 4-year colleges and universities, vocational-technical schools, and eligible foreign institutions. Any US resident who is at least age 18 years may invest in any state's plan.

Section 529 plans vary in their impact on eligibility for financial aid. Currently, prepaid tuition plans have a very high impact on such eligibility. Prepaid tuition plans are treated as a resource, which means they reduce need-based financial aid by 100%, yielding a dollar-for-dollar reduction in aid. Section 529 college savings plans are treated as an asset of the account owner (typically the parent), and thus have a low impact on financial aid eligibility. Distributions from a college savings plan are not counted as untaxed income or a resource. The following are descriptions of two types of Section 529 plans.

Prepaid Tuition Plans

These allow you to “lock in” future tuition rates at current prices, offering peace of mind to the student's parents. Most of these plans offer a better rate of return on your investment than bank savings accounts and CDs. You should check with the plan's sponsor for age or grade requirements for students.

Steve Williams, CPA, is partner in charge of health care services at HMWC CPAs & Business Advisors in Tustin, Calif, specializing in consulting services to medical practices, as well as tax and financial planning. He may be contacted at steve@hmvccpa.com.

College Savings Plans

These plans provide more options than do prepaid tuition plans, but do not offer a guaranteed tuition rate. There is no “lock” on tuition rates, and no guarantee. Investments are subject to market conditions, and the savings may not be sufficient to cover all college costs. However, with this added risk comes the potential for earning greater returns. These plans have no age limits for students.

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HIRING YOUR CHILDREN

From a tax perspective, hiring your children can reduce taxation on many fronts. The main tax benefit of hiring children is that it allows business owners to shift income

out of the business to the child, who can either shelter that income from taxes entirely, or have it taxed at a reduced rate compared with the parent. Plus, you can deduct the compensation as a business expense, reducing your gross income. A child’s earning limit is adjusted annually for inflation, and reflects the standard deduction amount for a single filer. Also, your child may be required to file a return if he or she has investment income as well as wages.

Hiring children also makes good business sense for a number of reasons, including:

- **Hiring concerns:** Family members can be more dedicated workers and are generally more trustworthy.
- **Health insurance:** You can write off the total cost of coverage as a business expense, and establish a tax-deductible reimbursement plan to deduct medical expenses not covered by insurance.
- **Retirement savings:** As a child earns wages, he or she can establish an Individual Retirement Account for tax-deferred retirement savings, which is especially beneficial in terms of long-term growth opportunity.

When hiring children, consider the following “dos and don’ts”:

- Do have your child perform actual work that is necessary for your business
- Don’t hire your child for a job that he or she is not qualified to do
- If possible, don’t assign the child to work directly for a parent or sibling
- Do prepare a job description
- Do fully inform the new employee (your child) what to expect and what is expected of him or her
- Do document the type of work your child performs, including detailed time records
- Do pay market wages, similar to what you would pay for someone else to do the same job
- Do put him or her on the payroll as you do with all your employees, and keep canceled checks or pay stubs
- Do complete a W-4 wage form for each child who works for you
- If possible, do place your child in a position where he or she can receive honest feedback on job performance.

TRANSFERRING INCOME-PRODUCING ASSETS

Income-producing assets can be legally transferred to your children, which can help you save taxes. However, this strategy has inherent limitations on tax savings opportunities due to the so-called “kiddie tax.” Under the kiddie tax, children are allowed the first \$850 in “unearned income” on a tax-free basis. Unearned income can include interest, dividends, and capital gains. The next \$850 is taxed at your child’s own rate, usually 10% or 15%. After that, any unearned income over \$1,700 is taxed at your marginal rate.

Under the 2005 Tax Increase Prevention and Reconciliation Act, which became effective in 2006, the cutoff age for the kiddie tax has been raised from age 14 to 18 years (ie, the child must have reached age 18 years during the year to avoid the tax). These new rules affect income-shifting strategies. If you have children who are younger than age 18 years, consider trying to keep their investment income below \$1,700 for the year. Up to that amount, the children will be taxed at lower rates; higher income will be taxed at your rate.

You do not necessarily need to wait until your kids reach age 18 years to transfer appreciated assets to them. The sooner you begin, the more assets you will be able to transfer to your children under the annual gift-tax exclusion, which is currently limited to \$12,000 per recipient per year.

If you have children aged 18 years and older, shifting income-producing assets can save tax dollars. All of the children's income (both earned and unearned) will be taxed at their own marginal rates, which will generally be lower than your own. For example, suppose you give \$25,000 in stock to your 19-year-old child that you had purchased for \$10,000. If your child immediately sells the stock, the gain is \$15,000, which would have resulted in a tax of \$2,250 at your rate (15%). Assuming your child is in the 15% tax bracket, the capital gain would be taxed at only a 5% rate, for a tax of \$750. The resulting net tax savings is \$1,500.

Of course, children over age 18 years are legally allowed unrestricted access to "gifted" funds such as these. However, if you

are confident that your child will use these funds for constructive purposes (eg, education expenses), it can be a great tax-saving technique. Further, your child may qualify for education credits that you could not claim if you paid the expenses, due to income phase-outs that apply to those credits.

CONCLUSION

Section 529 plans can be initiated soon after your child's birth. Other strategies, such as hiring your child and transferring assets, vary in workability and benefits according to the child's age. This suggests that your approach to income-shifting will

change over time, and you should consult your financial adviser periodically to keep abreast of age-related adjustments and changes in pertinent state and federal laws.

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