Tax-Advantaged College Strategies

Prepared For

THE SAMPLE FAMILY

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Section I - Education Tax Benefits

Many parents are faced with the challenge of having adequate resources to pay (or help pay) for college education for their children. Fortunately, there are a number of options available to meet this objective with substantial income tax savings. This section explains the tax benefits that are available to individuals who are saving for or paying for higher education costs. A summary of these benefits is provided at the end of this section.

SAVING AND PAYING FOR COLLEGE

Aside from the tax benefits, families planning for college costs will want to be well-informed about the best choices for their financial situation and for their student's age. The earlier saving starts, the more time there is for investments to grow. Caution is needed when choosing savings vehicles because the aid formulas treat these accounts differently. In general, the formulas expect a much higher contribution to college costs from assets held in a student's name. Some families will want to be sure to position their assets in such a way as to maximize their ability to qualify for financial aid, while others will want to position their assets so as to maximize their tax savings. It will be a good idea to talk with a consultant who is knowledgeable about both tax rules and student financial aid.

<u>Coverdell Education Savings Accounts</u>
A Coverdell education savings account (ESA) is a trust account established to pay education expenses of a designated beneficiary. Any individual, including the child, can make contributions. There is no limit to the number of ESAs that can be established for a beneficiary, however the total contribution to all accounts on behalf of any one beneficiary is limited to an annual amount. Contributors are subject to an AGI phase-out range (see Appendix 1). Contributions are not allowed for a beneficiary over age 17, unless the beneficiary has special needs that require additional time to complete his/her education. If a balance remains in an ESA when the beneficiary reaches age 30, the balance must be distributed (subject to tax and 10% penalty on the growth) or rolled over to a new, younger family member.

Contributions to an ESA are not deductible, but earnings in the account are tax-free if used for qualified education expenses, including tuition and fees, books, supplies and equipment, room and board if at least half-time attendance, payments to a QTP, and computer and internet service. These expenses can be for grades K-12, and both undergraduate and graduate college education. Only cash contributions are permitted, and contributions in excess of the annual limit will be subject to an excise tax.

Federal aid formulas count parent-owned ESAs for dependent students and their siblings as parent assets; they do not count distributions from these accounts as income.

<u>Qualified Tuition Programs (529 Plans)</u>
Qualified Tuition Programs (also known as 529 plans after the IRS code that regulates them) allow a taxpayer to make contributions to be used for higher education. There are two types of plans, prepaid programs and savings plans.

Prepaid tuition programs allow the taxpayer to purchase tuition credits, and are generally based on the tuition price at public colleges in the states that offer them. (Some states allow the credits to be used at private colleges as well.) Residents of the state can protect themselves against increases in college costs by purchasing a guarantee of future credits toward college tuition. Each state administers their own prepaid plan with its own regulations, guarantees, costs, benefits and penalties if the credits aren't used. Keep in mind that room and board are significant expenses that are not included in "tuition".

Savings plans are established to pay for qualified higher education expenses at *any* qualified education institution, and are thus more popular than prepaid plans.

Contributions to 529 plans are not deductible on your federal tax return, but some states will allow a deduction for residents. Earnings in the account are tax-free if used for qualified education expenses, including tuition and fees, books, supplies and equipment, room and board if at least half-time attendance, and computer and internet service. The expenses can be for both undergraduate and graduate course work.

The amount contributed to a 529 is limited to "the amount necessary to cover qualified expenses of the beneficiary", which varies by plan. Contributors are NOT subject to any income limitations, meaning even high earners can contribute to 529 plans. Contributions are subject to the annual gift tax exclusion, however contributors can take a 5-year election, which allows them to make contributions larger than the annual gift exclusion and spread them ratably over five years. (see Appendix 2)

Parent-owned 529 plans for dependent students, including both the college bound student *and* siblings, are considered parent assets on the FAFSA.

Uniform Gifts to Minors and Uniform Transfers to Minors

Custodial accounts may be opened in the name of a minor under the Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). By law, minors can't own securities outright. UGMAs and UTMAs allow minors to enjoy the benefits of owning securities within the limits of the law. The account belongs to the child, who can use it for *any* purpose (not limited to education) when he/she is no longer a minor. The termination age can vary from one state to another, but generally the termination age is 18 years for the UGMA and 21 years for the UTMA. Contributions are subject to gift tax limits (see Appendix 2), and earnings on these accounts are subject to the Kiddie Tax rules. (see Appendix 3)

Funds in an UGMA or UTMA account are considered student assets on the FAFSA, and therefore have greater impact on financial aid eligibility than parent-owned assets.

Education Savings Bonds

All or part of the interest earned on Series EE and Series I bonds issued in 1990 or after may be excluded from income if the bonds are used for education expenses in the year redeemed. To qualify for this exclusion, the bond owner must have been at least 24 years old before the bond's issue date. Qualified expenses must be for the taxpayer, spouse, or dependent, and can include tuition and fees for undergraduate or graduate school, and contributions to an ESA or a 529 plan. (Room, board and books do not qualify.) This exclusion is subject to an income limitation in the year the bonds are redeemed (see Appendix 4) and is not available to married taxpayers filing separately.

IRA Withdrawals
Taxpayers are allowed to make penalty-free withdrawals from Individual Retirement Accounts (IRAs) for qualified education expenses. These expenses can be for the taxpayer, spouse, child or grandchild for either graduate or undergraduate studies, and can include tuition and fees, books, supplies and equipment, room and board if at least half-time attendance, and computer and internet service.

Although a withdrawal for qualified college expenses will not be subject to the customary 10% penalty, the IRA owner *will* have to include the withdrawal on his tax return and pay ordinary income tax on it. This can be detrimental to a family who may qualify for financial aid, as it must be included as income on the FAFSA in the year it is withdrawn.

Scholarships, Grants and Fellowships
Certain scholarship, grant and fellowship amounts received by a degree candidate and used for tuition and required fees, books, supplies and equipment are generally excluded from income. (Room and board does not qualify.) Tax is due on any part of the scholarship, grant or fellowship that represents payment for services required as a condition of the scholarship, even if all candidates are required to perform the services.

Employee/Grad Student Tuition Discounts
If an educational institution offers discounted tuition to its employees and/or their children, the reduction is not taxable if it is for undergraduate education and is not given in exchange for work.

If a graduate student is teaching or doing research at an educational institution in exchange for education (rather than for pay) the graduate student does not have to pay tax on the amount of the tuition reduction.

TAX CREDITS

American Opportunity Tax Credit
The American Opportunity Tax Credit allows a taxpayer to claim a tax credit (a direct reduction of taxes owed) of up to $2,500 *per student* per year (calculated as 100% of the first $2,000 of expenses and 25% of the next $2,000). A portion of the credit, 40%, is refundable, meaning it will result in a tax refund if you don't have a tax liability. The expenses must be for the first four years of undergraduate study and the student must be enrolled at least half-time in a degree program. This credit can be claimed for qualified education expenses, including tuition, fees, books, supplies and equipment, for the taxpayer, spouse or a dependent. (Room and board does not qualify.) The credit is subject to an income phase-out range (see Appendix 5) and is not available to married taxpayers filing separately.

Parents can shift this credit to their children by not claiming them as a dependent. However, an 18-year old child (or a full time student age 19-23) who qualifies as a dependent on their parents' tax return cannot claim a personal exemption on his/her own tax return, even if the parents choose not to claim them. A dependent student claiming this credit on his/her tax return only qualifies for the nonrefundable portion of this credit, not the refundable portion.

Lifetime Learning Credit

The Lifetime Learning Credit allows a taxpayer to claim a tax credit (a direct reduction of taxes owed) of up to $2,000 *per tax return* per year (calculated as 20% of up to $10,000 of expenses). This credit is not refundable, meaning it can only reduce your tax liability to zero; it will not result in a tax refund. The credit is available for an unlimited number of years for both degree and non-degree programs. There is no workload requirement; this credit is allowed regardless of the number of courses taken. This credit can be claimed for qualified education expenses, including tuition, fees, books, supplies and equipment, for the taxpayer, spouse or a dependent. (Room and board does not qualify.) The credit is subject to an income phase-out range (see Appendix 6) and is not available to married taxpayers filing separately.

Parents can shift this credit to their children by not claiming them as a dependent. However, an 18-year old child (or a full time student age 19-23) who qualifies as a dependent on their parents' tax return cannot claim a personal exemption on his/her own tax return, even if the parents choose not to claim them.

TAX DEDUCTIONS

Tuition and Fees Deduction

Taxpayers are allowed to claim an above-the-line deduction (meaning you don't have to itemize deductions to take it) of up to $4,000 for qualified education expenses paid per year, for both undergraduate and graduate courses for the taxpayer, spouse or a dependent. This deduction can be claimed for qualified education expenses, including tuition, fees, books, supplies and equipment. (Room and board does not qualify.) This deduction is subject to income limits (see Appendix 7) and is not available to married taxpayers filing separately, or to any taxpayer who qualifies as a dependent on another taxpayer's return.

Student Loan Interest Deduction

Taxpayers are allowed to claim an above-the-line deduction (meaning you don't have to itemize deductions to take it) for qualified student loan interest paid per year, limited to a maximum annual amount. (see Appendix 8) This deduction can be for undergraduate and graduate courses for the taxpayer, spouse or a dependent. Qualifying loans must be taken out solely to pay qualifying education expenses, including tuition, fees, books, supplies and equipment, room and board, transportation and other necessary expenses. Students must be enrolled at least half time in a degree program. This deduction is subject to income limits (see Appendix 8) and is not available to married taxpayers filing separately, or to any taxpayer who qualifies as a dependent on another taxpayer's return.

In order to deduct this interest, the taxpayer must have primary obligation to repay the loan, and actually pay the interest during the tax year. For example, a student has primary obligation to repay a Stafford loan. Therefore, his parents cannot claim a deduction for any interest they pay on this loan on their student's behalf. Also, if the student pays interest on this loan while he is in school, he cannot deduct the interest if his parents claim a dependency exemption for him. If he chooses not to make any payments on this loan until after he graduates, he will no longer be a dependent and can claim the student loan interest deduction on his tax return.

Loans from related parties (siblings, spouses, parents, grandparents, and certain corporations, partnerships, and trusts) and loans from qualified employer plans (like 401k plans) do not qualify.

COORDINATION OF EDUCATION TAX BENEFITS

Taxpayers generally cannot claim more than one of the tax benefits for *the same* qualifying education expenses.

Qualifying education expenses are generally applied in the following order:
1) Nontaxable income, such as scholarships and employer education assistance.
2) Amounts used to claim education credits
3) 529s and ESAs (allocated equally if distributions total more than remaining expenses)

Contributions may be made to an ESA and a 529 plan for the same beneficiary in the same year.

An education credit (American Opportunity or Lifetime Learning) can be claimed in the same year that a tax-free distribution is received from a 529 account if the 529 distribution is not used for the same qualified expenses used to claim the education credit.

A taxpayer may not claim both an American Opportunity Credit and a Lifetime Learning Credit for the same student in the same year. A family with more than one student can choose to take the credits on a per-student, per-year basis. For example, the American Opportunity Credit can be claimed for one student and the Lifetime Learning Credit claimed for another student in the same year.

For each eligible student, the taxpayer can claim either the Tuition & Fees Deduction *or* an education credit (American Opportunity or Lifetime Learning), but not both.

Taxpayers taking an education credit (American Opportunity or Lifetime Learning) or the Tuition and Fees deduction can also take a student loan interest deduction.

Summary of 2013 Education Tax Benefits

	American Opportunity Credit	Lifetime Learning Credit	IRA Withdrawals	Savings Bond Interest Exclusion	Student Loan Interest Deduction	Tuition & Fees Deduction	Qualified Tuition Program (529)	Education Savings Account
Tax Benefit	Tax credit that is 40% refundable (nonrefundable under certain conditions)	Nonrefundable tax credit	10% early withdrawal penalty is waived	Interest is excludable from income	Above-the-line deduction	Above-the-line deduction	Earnings not taxed (savings plan) or tax-free education credits (prepaid plan)	Earnings not taxed
2013 Annual Limits	Credit up to $2,500 per student (100% of first $2,000 of expenses and 25% of next $2,000)	Credit up to $2,000 per return (20% of up to $10,000 of expenses)	Amount of qualifying expenses	Amount of qualifying expenses	Deduction of up to $2,500 of interest paid on education loan	Deduction of up to $4,000 of qualifying expenses paid	Nondeductible contributions limited to amount necessary to cover qualified expenses	$2,000 nondeductible contribution per child under age 18 and any age special-needs child
Qualified Education Expenses **(Must be reduced by any tax-free scholarships or grants. The same educational expenses can't be used for figuring more than one benefit.)**	Tuiton and fees; books, supplies and equipment (must be required for enrollment)	Tuiton and fees; books, supplies and equipment (must be purchased from the institution and required for enrollment)	Tuiton and fees; books, supplies and equipment (must be required for enrollment); room and board if at least half time; computer and internet service	Tuiton and fees; contributions to QTPs and ESAs	Tuiton and fees; books, supplies and equipment; room and board; transportation; other necessary expenses	Tuiton and fees; books, supplies and equipment (must be purchased from the institution and required for enrollment)	Tuiton and fees; books, supplies and equipment; (must be required for enrollment) room and board if at least half-time; computer and internet service	Tuiton and fees; books, supplies and equipment; (must be required for enrollment) room and board if at least half-time; computer and internet service; payments to QTP
QEE must be for…	Taxpayer, spouse or dependent	Taxpayer, spouse or dependent	Taxpayer, spouse, child or grandchild	Taxpayer, spouse or dependent	Taxpayer, spouse or dependent	Taxpayer, spouse or dependent	Account beneficiary	Account beneficiary
Qualifying Education	First four years of undergraduate	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate	K-12, undergraduate and graduate
Other Rules and Requirements	Must be enrolled at least half-time in a degree program; parents can shift credit to student by not claiming student as dependent	Available for unlimited number of years for degree and non-degree programs; parents can shift credit to student by not claiming student as dependent	Penalty waived on distributions up to the amount of qualified expenses for the year	Applies only to qualified Series EE bonds issued after 1989 or Series I bonds; bond owner must be at least 24 years old when bond issued	Must be enrolled at least half-time in a degree program; loan must be incurred solely to pay qualified education expenses; Payer must be legally obligated to repay debt	Not allowed if education expenses are deducted under another provision or education credit is claimed	Account owner can change beneficiary or reclaim funds; can elect to spread gift over five years; some states allow deduction; beneficiary can be anybody	Contributions must be made by the original return due date; may also contribute to QTP; mandatory distributions at age 30; beneficiary can be anybody
Modified AGI Phase-Out **MFJ…..** **Single, HOH, QW…..** **MFS…..**	 $160,000 - $180,000 $80,000 - $90,000 Do Not Qualify	 $107,000 - $127,000 $53,000 - $63,000 Do Not Qualify	N/A	 $112,050 - $142,050 $74,700 - $89,700 Do Not Qualify	 $120,000 - $150,000 $60,000 - $75,000 Do Not Qualify	Not allowed if AGI exceeds: $160,000 $80,000	N/A	 $190,000 - $220,000 $95,000 - $110,000 $95,000 - $110,000

APPENDIX

1) The annual contribution limit for Coverdell Education Savings Accounts is $2,000. The modified AGI Phase-out range for 2013 is as follows:
   MFJ -- $190,000 - $220,000
   Single, HOH, QW, MFS -- $95,000 - $110,000

2) For 2013, the annual gift tax exclusion amount is $14,000 per recipient. Married couples can choose to "gift split" and gift $28,000 per recipient per year. For the 5-year election, an individual can contribute $70,000 ($14,000 x 5) to a QTP without gift tax consequences provided no other gifts are made to the beneficiary for the next five years.

3) Kiddie Tax rules say that for dependents who are either under age 18, or age 18 (or a full-time student age 19-23) and his earned income is less than or equal to half of his own support, investment earnings in excess of $2,000 will be taxed at the parents' tax rate. Earned income is not subject to Kiddie Tax, only unearned (investment) income.

4) The modified AGI Phase-out range for savings bond interest exclusion is:
   MFJ -- $112,050 - $142,050
   Single, HOH, QW -- $74,700 - $89,700
   MFS – Do Not Qualify

5) The modified AGI Phase-out range for the American Opportunity Tax Credit is:
   MFJ -- $160,000 - $180,000
   Single, HOH, QW -- $80,000 - $90,000
   MFS – Do Not Qualify

6) The modified AGI Phase-out range for the Lifetime Learning Credit is:
   MFJ -- $107,000 - $127,000
   Single, HOH, QW -- $53,000 - $63,000
   MFS – Do Not Qualify

7) The income limits for the Tuition and Fees $4,000 Deduction are:
   MFJ -- $130,000
   Single, HOH, QW -- $65,000
   MFS – Do Not Qualify
   The income limits for the Tuition and Fees $2,000 Deduction are:
   MFJ -- $130,001 - $160,000
   Single, HOH, QW -- $65,001 - $80,000
   MFS – Do Not Qualify

8) For 2013, the maximum deduction for student loan interest is $2,500. The modified AGI Phase-out range for the Student Loan Interest Deduction is:
   MFJ -- $125,000 - $155,000
   Single, HOH, QW -- $60,000 - $75,000
   MFS – Do Not Qualify

Section II – Tax-Advantaged College Planning Strategies

Often times, college planning entails helping a family increase their opportunity to qualify for financial aid. But what can be done for families who will likely NOT qualify for financial aid, given their income level and/or countable assets? This section explains how shifting income by moving assets into the *student's* name can help a family pay for college in a tax-advantaged way. Since student assets are assessed more heavily on the FAFSA than parent assets, THIS STRATEGY SHOULD ONLY BE IMPLEMENTED BY FAMILIES WHO WILL NOT LIKELY QUALIFY FOR NEED-BASED FINANCIAL AID.

OVERVIEW

RESTRAINTS

- Tax Capacity
- Gift Tax
- Kiddie Tax

CAPITAL GAINS

"ASSET GIFTING" STRATEGY DIAGRAM

OVERVIEW

In *tax-advantaged* college planning, income and assets are better off in the student's name. This is different from *aid-advantaged* planning, where income and assets are better off in the parents' name. It is critical to know whether or not you will qualify for financial aid, so you know which strategy (tax-advantaged or aid-advantaged) to implement.

The purpose of aid-advantaged planning is to maximize the amount of financial aid a family will qualify for, in order to decrease their out of pocket cost. The purpose of tax-advantaged planning is to increase family funds available for *future* college costs by reducing taxation. In other words, every dollar saved on taxes is a dollar in your pocket that can then be put towards future college costs.

In the United States, we are subject to a progressive tax system, meaning the tax rate increases as taxable income increases. This type of tax system is designed to reduce taxes for those with a lower ability to pay them and conversely, to increase taxes for those with a higher ability to pay. However, the progressive nature of this system leaves the door open for "income shifting" – a strategy of moving a person's income from a higher income tax bracket to a lower one.

Unfortunately, a taxpayer does not have unlimited ability to shift income because the IRS has implemented Gift Tax limits and Kiddie Tax rules in order to limit such shifts. In this section, we will explore how to shift income from the parents to the student, within these constraints.

RESTRAINTS

Tax Capacity

Tax capacity is the amount of income that can be shifted to a child, and have the child still be taxed in a lower tax bracket than the parents' tax bracket. For example, in 2014, a single tax payer can report gross income of up to $47,050 (resulting in $36,900 of taxable income after the $6,200 standard deduction and $3,950 personal exemption) and still be in the 15% marginal tax bracket.

For 2014, a college student not subject to the kiddie tax can report between $23,150 and $29,800 of ordinary taxable income for purposes of utilizing the entire American Opportunity tax credit, and $26,500 for the Lifetime Learning credit. (Please see the Summary of Education Tax Benefits in Section I for details on these credits.)

Gift Tax

The federal gift tax system was created to prevent individuals from avoiding estate taxes by giving away their money before they die. This tax is owed by the giver of the gift, not the recipient.

It also impedes the ability to shift income to your children, because the amount of assets you can gift to them each year is subject to gift tax rules. The IRS allows taxpayers to give up to the annual exclusion amount (see Appendix 2) to each recipient per year without being subject to any gift tax filing requirements. Amounts over and above the annual exclusion apply towards the lifetime exemption (see Appendix 2), and amounts over the lifetime exemption will be subject to a gift tax. Contributors to a 529 plan can take a 5-year election, which allows them to make contributions larger than the annual gift exclusion and spread them ratably over five years. (see Appendix 2)

For tax purposes, a gift is a transfer of property for less than its full value. Gifts can include transfers of cash or property, interest-free loans, below-market sales, irrevocable transfers to trust, and the creation of certain joint tenancies. Note that tuition paid *directly to an educational institution* for another person is NOT considered a gift for gift tax purposes.

Kiddie Tax

The kiddie tax was created to prevent parents from sheltering income by putting investment accounts in the name of their lower-taxed kids. When it was first created in 1986, the tax only applied to children under age 14. The law has since been expanded to include children a) under age 17, and b) age 18 (or a full-time student age 19-23) with earned income less than or equal to half of their support. Support includes amounts spent for food, lodging, clothing, education, medical care, recreation, transportation and other necessities. (A scholarship is not considered support if the child is a full-time student.)

Kiddie tax rules apply only to investment earnings, and only if the child has more than $2,000 of investment income for the year. Wages received by a child are always taxed at the child's normal tax rate.

Kiddie Tax Summary	Under age 18 Age 18 (or a full time student age 19-23) **with earned income that is *less than or equal to half* of his/her support**	Age 18 (or a full time student age 19-23) **providing *more than half* of his/her financial support**
Subject to kiddie tax?	Yes	No
Investment Income Only	$0-1,000…………Not taxed $1,001-2,000…....Child's rate **Over $2,000…...Parents' rate**	$0-1,000…………Not taxed **Over $1,000……..Child's rate**
Both earned and investment income	*Investment income:* $0-1,000……….Not taxed $1,001-2,000…..Child's rate **Over $2,000….Parents' rate** *Earned income:* Earned income minus remaining amount of standard deduction…………..Child's rate	Total income minus the standard deduction………Child's rate
Qualify as dependent on parents' tax return?	Yes	No
Can claim personal exemption on his/her own return?	No	Yes

An 18-year old child (or a full time student age 19-23) who qualifies as a dependent on their parents' tax return cannot claim a personal exemption on his/her own tax return, even if the parents choose not to claim the exemption.

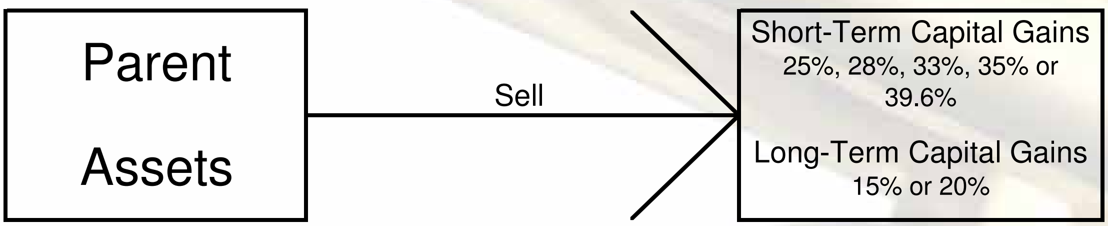
CAPITAL GAINS

A sale or exchange of a capital asset (an asset owned for personal or investment purposes) results in a capital gain or loss. The tax rate on a capital gain depends on the holding period, the type of asset, and the taxpayer's ordinary income tax bracket. Short-term capital gains (assets held one year or less) are taxed at ordinary income tax rates; long-term capital gains (assets held longer than one year) are 0% for taxpayers in the bottom two ordinary income tax brackets (10% and 15%), 15% for the 25%, 28%, 33% and 35% income brackets, and 20% for the 39.6% income bracket. Ordinary dividends are taxed at ordinary income tax rates; qualified dividends (holding period greater than 60 days for common stock and 90 days for preferred stock) are taxed at long-term capital gains rates.

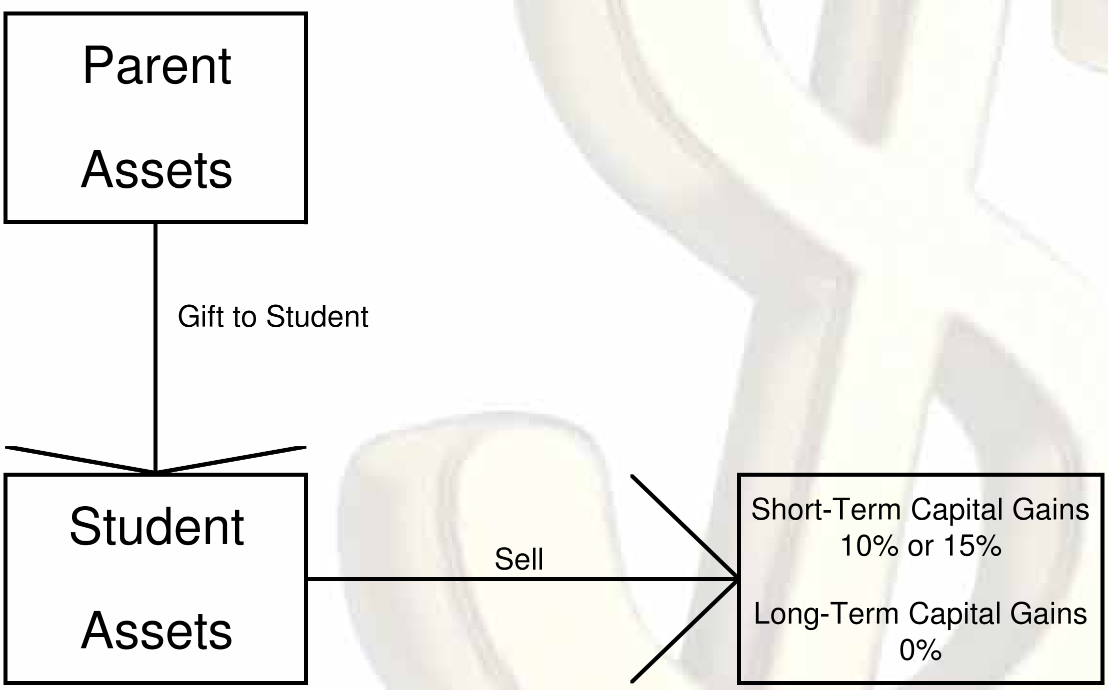
This presents an opportunity to shift income from the parents (who likely would pay a 35% or 39.6% short-term capital gains rate and a 15% or 20% long-term capital gains rate) to the student (who will pay a 10-15% short-term capital gains rate and a 0% long-term capital gains rate). The challenge is shifting this investment income from the parents to the student, within the constraints of the gift tax limits, the kiddie tax rules, and the student's tax capacity.

Asset Gifting Strategy

Without gifting:



With gifting:



Section III – Tax-Advantaged College Planning Strategies for Small Business Owners and Investment Property Owners

In addition to the income shifting strategies outlined in Section II, **parents who are small business owners and/or rental property owners have additional college funding tools available to them that other families don't have.** This section explains the strategies that can be implemented by small business owners and rental property owners to help them fund college education for their children in a tax-advantaged way. Bear in mind that THESE STRATEGIES SHOULD ONLY BE IMPLEMENTED BY FAMILIES WHO WILL NOT QUALIFY FOR NEED-BASED FINANCIAL AID.

OVERVIEW

If you own and control a family business with fewer than 101 full-time employees, your business equity (business assets minus liabilities) does NOT have to be reported on the FAFSA. The US Department of Education defines a "family business" as one where the family owns more than 50% of the value of the business. Family can include relatives by blood (such as cousins, nieces and nephews) or by marriage.

Investment properties DO have to be listed on the FAFSA as an asset; the amount is required to be the equity in the property, which is defined as the current market value minus what you owe on the property. Also, any income generated from the property will be included in your income and count against you in the financial aid formulas.

Small business owners and investment property owners have income shifting strategies available to them that will help them pay for college in a more tax-advantaged way.

COMPENSATING THE STUDENT

This strategy involves hiring your student as an employee and putting them on your business payroll. Since this strategy may put the student's income over the student income protection allowance on the FAFSA, this strategy should only be implemented by families who will not likely qualify for need-based financial aid. The purpose of this strategy is to shift income to the student, in hopes that the student can then qualify for education tax benefits that the parents are phased out of due to their high income level. As we said in Section II, this kind of college planning will not reduce your immediate out-of pocket cost, but rather will increase family funds available for *future* college costs by reducing taxation. In other words, every dollar saved on taxes is a dollar in your pocket that can then be put towards future college costs.

<u>IRS Rules for Employing Child Family Members</u>
The IRS rules say that if you employ your child, the work they perform must relate to your business or rental property, the child must actually render the services, the child must actually be paid, all required "employee" paperwork must be filled out, and the rate of pay must be reasonable in relation to the work performed. Be sure to keep good written records, such as a time sheet showing detail of hours worked and work performed.

Favorable payroll tax rules apply for parent-owned unincorporated businesses, including sole proprietorships and partnerships where the only partners are the child's parents. In these cases, a child under age 18 is exempt from FICA (Social Security and Medicare) taxes and a child under age 21 is exempt from FUTA (Federal Unemployment) tax.

<u>Advantages of Earned Income</u>
If students are able to provide more than half of their own support through earned income, then they are not subject to kiddie tax rules, so the $2,000 investment income limit will not apply to them (although they will still be subject to gift tax limits). Also, if a

student has earned income, they can file their own tax return and take advantage of education tax benefits that their parents are likely phased out of due to income thresholds. A student with earned income can contribute to a Roth or traditional IRA. Lastly, the student can participate in an employer-provided Education Benefits Plan.

Employer-Provided Education Benefits

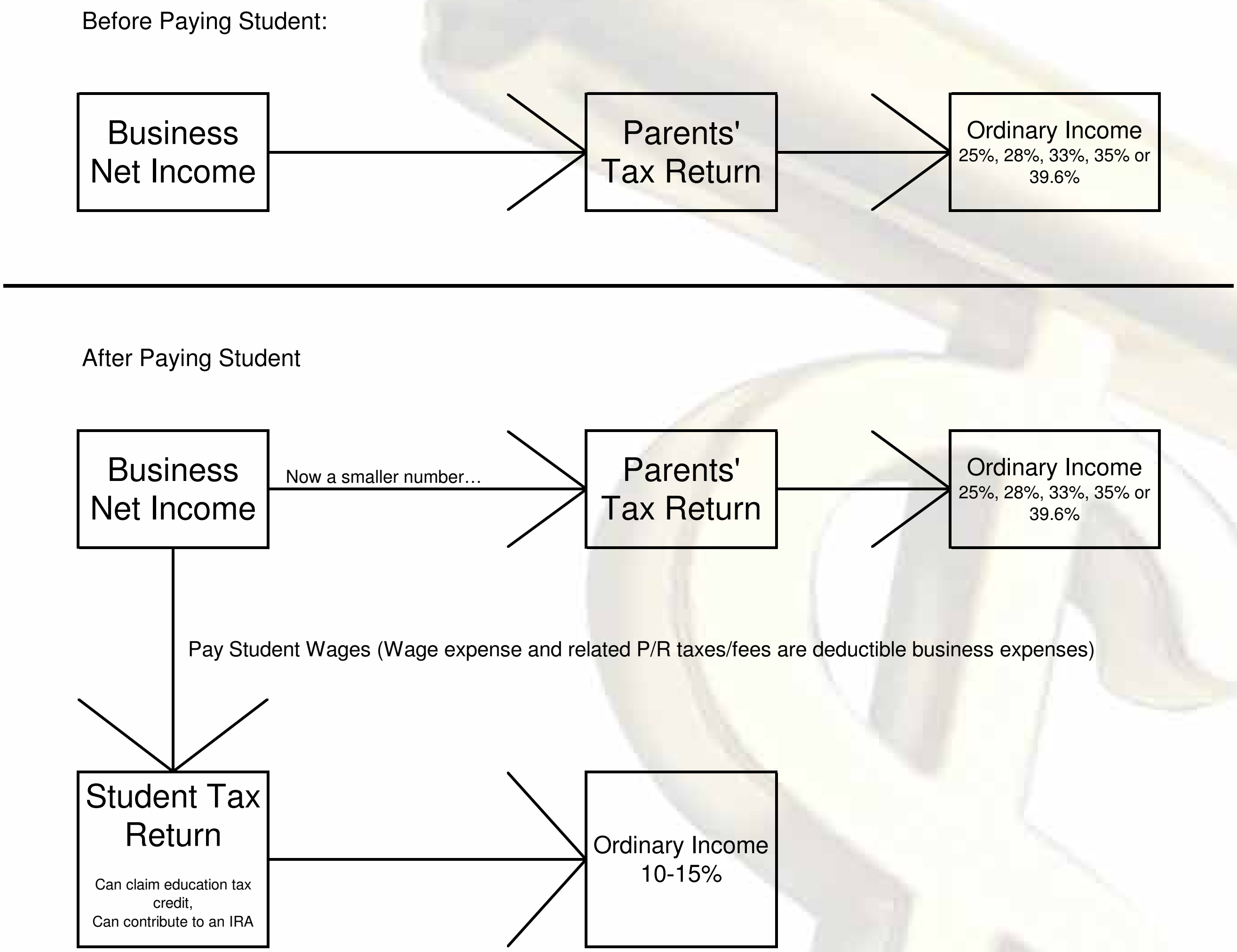
Employees may exclude $5,250 of employer-provided education benefits from gross income. The benefits can be for tuition, fees, books, supplies and equipment for undergraduate or graduate courses.

The plan must be open to all employees seeking graduate or undergraduate education, and a formal, written plan must exist. Employers have many options when designing and developing their Education Assistance Plan, such as a minimum grade point average, a sliding scale of payment based on grades, funding only certain majors, paying directly to the education institution or the employee, and a minimum employment requirement after the degree is received.

A family who owns a business has a unique opportunity to take advantage of such a program to pay for college expenses of their adult children with pre-tax dollars. The plan must meet IRC Section 127 requirements and the participants must be 21 years old and financially independent (providing over half of their own support) for tax purposes. The student must be formally, factually and consistently employed by the parents' company with a reasonable amount of wages paid in any plan year.

Not all self-employed situations will qualify but for the ones that do, this is a great benefit. For example, a family in the 35% tax bracket would have to earn $8,076 pre-tax in order to pay a $5,250 tuition bill. With an employer-provided education benefit plan, they pay that $5,250 tuition through their small business and deduct it as a plan expense, thereby saving $1,838 (35% of $5,250) on taxes. That's a $4,664 swing per child per year.

Compensating a Student Strategy



Section IV – Customized Reports

These reports were prepared with financial and student data supplied by the client.

SUPPORT DETAIL

RECOMMENDATIONS REPORT

"WHAT-IF" COMPARISON REPORTS

TOTAL SAVINGS PROJECTION REPORT

TAX CAPACITY REPORT

Sam & Sally Sample
Support Detail

Student name:	Charlie
Full-time Student?	Yes

Annual amount spent on:	
Food & Lodging	$10,000
Clothing	$400
Education *	$30,000
Medical Care	$2,000
Recreation	$200
Transportation	$800
Other Necessitites	$100
Total support	$43,500
Half Support	$21,750

* Report education expenses NET of any scholarships if the student is full-time.
If the student is half-time or less, report GROSS expenses before any scholarships.

Sam & Sally Sample
Recommendations Report

Recommendations:

1) Sample Supply Center qualifies as a "family" business as defined by the US Dept of Education, as it is 100% owned by Sam and has fewer than 101 employees. Therefore, do not include net business equity as an asset on the FAFSA. However, you DO need to include net business equity on the CSS PROFILE form. (Some, but not all, private schools require this form in addition to the FAFSA.)
2) Charlie is added to the Sample Supply Center payroll while in college, see Scenarios A, B, & C below.
3) Christie is added to the Sample Supply Center payroll while in high school, see Scenario D below
4) Sample Supply Center may want to establish an Employer Education Assistance Program (EEAP), however be sure to consider impact of other employees taking advantage of this benefit
   - $5,250 (per 21-year old student per year) is a deductible business expense (Employee Benefits)
   - Recipients DO NOT have to claim this as income
   - Please see "Employer-Provided Education Benefits" in Section III
5) In years where Charlie's salary is more than half of his support, appreciated assets can be gifted to him without the constraints of the Kiddie Tax Rules. Please see Section II for a detailed explanation of the Kiddie Tax rules, the Gift Tax limits and Tax Capacity

	College			High School
	Scenario A	**Scenario B**	**Scenario C**	**Scenario D**
Student Annual Wages [1]	$12,000	$17,000	$22,000	$5,000
More than 1/2 of their support? [2]	No	No	Yes	No
Is student subject to Kiddie Tax rules? [3]	Yes	Yes	No	Yes
Do Mom & Dad claim Student as a dependent? [4]	No	No	No	Yes
Can Student claim their own exemption? [5]	No	No	Yes	No
Can Student claim the standard deduction? [6]	Yes	Yes	Yes	Yes
Can Student claim the American Opportunity Tax Credit?				
Nonrefundable Portion (60%, $1,500 max)	Yes	Yes	Yes	N/A
Refundable Portion (40%, $1,000 max)	No	No	Yes	N/A
Can Student make an IRA contribution?	Yes	Yes	Yes	Yes

Notes:

1 Please see "IRS Rules for Employing Child Family Members" in Section III of this report.
2 "Support" includes amounts spent for food, lodging, clothing, education, medical care, recreation, transportation, and other necessities. A scholarship is not considered support if the child is a full-time student.
3 The Kiddie Tax rules apply to unearned (investment) income only, *not* earned income. Please see Section II for more on the Kiddie Tax.
4 In order for the Student to claim the American Opportunity Tax Credit, the parents cannot claim the Student as a dependent. However in some instances, it's better tax-wise for Dad and Mom to claim Student's exemption than for Student to take the American Opportunity Tax Credit.
5 An 18-year old child (or a full time student age 19-23) who qualifies as a dependent on their parents' tax return cannot claim a personal exemption on his/her own tax return, even if the parents choose not to claim the exemption.
6 For 2013, a dependent child's standard deduction is the greater of $1,000 *or* earned income plus $350, not to exceed $6,100.

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Sam & Sally Sample
"What-If" Comparison Report
(Using 2013 tax rates and 2013 tax data)

Scenario A	Pay Student $12,000		
	Sam & Sally		Charlie
	Before	After	After
W2 Wages	$ 250,000	$ 250,000	$ 12,000
S-Corp Income	$ 92,000	$ 78,797	$ -
Adjusted Gross Income	$ 353,363	$ 340,160	$ 12,000
Itemized (or Standard) Deductions[1]	$ 31,521	$ 31,917	$ 6,100
Exemptions ($3,900 each)[1]	$ 8,736	$ 7,722	$ -
Ordinary Income Tax	$ 77,779	$ 73,626	$ 593
AMT	$ 1,576	$ 1,108	
American Opportunity Credit (nonR)	$ -	$ -	$ (593)
American Opportunity Credit (R)	$ -	$ -	$ -
Federal Tax	$ 79,355	$ 74,734	$ -
INCOME TAX SAVINGS	**$ 4,153**			**$ 4,153**
Less - P/R Taxes				$ 1,203
Net Annual Tax Savings				**$ 2,950**

P/R Taxes	
FICA - SS (6.2%)	$ 744
FICA - Med (1.45%)	$ 174
FUTA (.6% on first $7,000)	$ 42
SUTA (2.7% on first $9,000)	$ 243
	$ 1,203

Notes

1) For 2013, itemized deductions and personal exemptions are limited for high earners. As such, as income goes down, deductibility of itemized deductions and personal exemptions will increase

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Sam & Sally Sample
"What-If" Comparison Report
(Using 2013 tax rates and 2013 tax data)

Scenario B	Pay Student $17,000			
	Sam & Sally		Charlie	
	Before	After	Rensselaer	
W2 Wages	$ 250,000	$ 250,000	$ 17,000	
S-Corp Income	$ 92,000	$ 73,415	$ -	
Adjusted Gross Income	$ 353,363	$ 334,778	$ 17,000	
Itemized (or Standard) Deductions[1]	$ 31,521	$ 32,079	$ 6,100	
Exemptions ($3,900 each)[1]	$ 8,736	$ 8,424	$ -	
Ordinary Income Tax	$ 77,779	$ 71,565	$ 1,193	
AMT	$ 1,576	$ 1,285		
American Opportunity Credit (nonR)	$ -	$ -	$ (1,193)	
American Opportunity Credit (R)	$ -	$ -		
Federal Tax	$ 79,355	$ 72,850	$ -	
INCOME TAX SAVINGS	**$ 6,214**			**$ 6,214**
Less - P/R Taxes				$ 1,586
Net Annual Tax Savings				**$ 4,629**

P/R Taxes	
FICA - SS (6.2%)	$ 1,054
FICA - Med (1.45%)	$ 247
FUTA (.6% on first $7,000)	$ 42
SUTA (2.7% on first $9,000)	$ 243
	$ 1,586

Notes

1) For 2013, itemized deductions and personal exemptions are limited for high earners. As such, as income goes down, deductibility of itemized deductions and personal exemptions will increase

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Sam & Sally Sample
"What-If" Comparison Report
(Using 2013 tax rates and 2013 tax data)

Scenario C	Pay Student $22,000					
	Sam & Sally			Charlie		
	Before	After	After w/ EEAP	After		
W2 Wages	$ 250,000	$ 250,000	$ 250,000	$ 22,000		
S-Corp Income	$ 92,000	$ 68,032	$ 62,782	$ -		
Adjusted Gross Income	$ 353,363	$ 329,395	$ 324,145	$ 22,000		
Itemized (or Standard) Deductions[1]	$ 31,521	$ 32,240	$ 32,398	$ 6,100		
Exemptions ($3,900 each)[1]	$ 8,736	$ 8,892	$ 9,360	$ 3,900		
Ordinary Income Tax	$ 77,779	$ 69,581	$ 67,642	$ 1,358		
AMT	$ 1,576	$ 1,385	$ 1,487			
American Opportunity Credit (nonR)	$ -	$ -	$ -	$ (1,358)		
American Opportunity Credit (R)	$ -	$ -	$ -	$ (1,000)		
Federal Tax	$ 79,355	$ 70,966	$ 69,129	$ (1,000)		
INCOME TAX SAVINGS	**$ 8,198**		**$ 10,137**	**$ 1,000**	**$ 9,198**	**$ 11,137**
Less - P/R Taxes					$ 1,968	$ 1,968
Net Annual Tax Savings					**$ 7,230**	**$ 9,169**

P/R Taxes	
FICA - SS (6.2%)	$ 1,364
FICA - Med (1.45%)	$ 319
FUTA (.6% on first $7,000)	$ 42
SUTA (2.7% on first $9,000)	$ 243
	$ 1,968

Notes

1) For 2013, itemized deductions and personal exemptions are limited for high earners. As such, as income goes down, deductibility of itemized deductions and personal exemptions will increase

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Sam & Sally Sample

"What-If" Comparison Report

(Using 2013 tax rates and 2013 tax data)

Scenario D *	Pay Student $5,000			
	Sam & Sally		Christie	
	Before	After	After [2]	
W2 Wages	$ 250,000	$ 250,000	$ 5,000	
S-Corp Income	$ 92,000	$ 86,453	$ -	
Adjusted Gross Income	$ 353,363	$ 347,816	$ 5,000	
Itemized (or Standard) Deductions[1]	$ 31,521	$ 31,688	$ 5,350	
Exemptions ($3,900 each)[1]	$ 8,736	$ 9,360	$ -	
Ordinary Income Tax	$ 77,779	$ 75,688	$ -	
AMT	$ 1,576	$ 1,726		
American Opportunity Credit (nonR)	$ -	$ -		
American Opportunity Credit (R)	$ -	$ -		
Federal Tax	$ 79,355	$ 77,414	$ -	
INCOME TAX SAVINGS	**$ 1,941**			**$ 1,941**
Less - P/R Taxes				$ 548
Net Annual Tax Savings				**$ 1,394**

P/R Taxes	
FICA - SS (6.2%)	$ 310
FICA - Med (1.45%)	$ 73
FUTA (.6% on first $7,000)	$ 30
SUTA (2.7% on first $9,000)	$ 135
	$ 548

Notes

1) For 2013, itemized deductions and personal exemptions are limited for high earners. As such, as income goes down, deductibility of itemized deductions and personal exemptions will increase
2) This pay level is for while Christie is in high school and since she won't be claiming the American Opportunity Tax Credit yet, Mom and Dad can still claim her as a dependent

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Sam & Sally Sample
Total Savings Projection

				College				High School
				Scenario A	Scenario B	Scenario C		Scenario D
School Year	P/R Year	College Student	HS Student	$12,000	$17,000	$22,000	$22,000 w/EEAP	$5,000
2014/15	2014	Charlie	Christie	$ 2,950	$ 4,629	$ 7,230	$ 7,230	$ 1,394
2015/16	2015	Charlie	Christie	$ 2,950	$ 4,629	$ 7,230	$ 7,230	$ 1,394
2016/17	2016	Charlie	Christie	$ 2,950	$ 4,629	$ 7,230	$ 9,169	$ 1,394
2017/18	2017	Charlie & Christie		$ 5,900	$ 9,257	$ 14,460	$ 16,399	$ 1,394
2018/19	2018	Christie		$ 2,950	$ 4,629	$ 7,230	$ 7,230	
2019/20	2019	Christie		$ 2,950	$ 4,629	$ 7,230	$ 9,169	
2020/21	2020	Christie		$ 2,950	$ 4,629	$ 7,230	$ 9,169	
				$ 23,600	**$ 37,028**	**$ 57,840**	**$ 65,596**	**$ 5,574**
			Scenario D	**$ 5,574**	**$ 5,574**	**$ 5,574**	**$ 5,574**	
				$ 29,174	**$ 42,602**	**$ 63,414**	**$ 71,170**	

Notes

These numbers were projected using 2013 tax laws and tables and have not been adjusted for inflation.
An EEAP is only appropriate for employees over age 21, so the EEAP savings amount is only used in the last two years of college in Scenario C

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The Pulse of Your Business

Sam & Sally Sample
Tax Capacity

	Scenario C
	$22,000
2013 Upper limit of 15% tax bracket for Single filers	$ 36,250
Standard Dedcution	$ 6,100
Personal Exemption	$ 3,900
Tax Capacity [1]	$ 46,250
Less: Wages	($22,000)
Investment Income Capacity	$ 24,250

Notes

1) Since tax brackets are determined by *net taxable income* , deductions and exemptions are added back to determine *gross income* allowed.

* A student escapes the Kiddie Tax only when they are providing more than half of their own support through their earned income, which only applies to Scenario C.

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