Tax Strategies for College Students of Higher Income Taxpayers

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Millions of students have either started or returned to college this fall. With the ever-increasing costs of a higher education, it's important that higher-income families try to develop an effective tax-planning strategy to combat some of these increased costs. Unfortunately, higher-income families generally do not have the availability of need-based college financial aid and must, thus, find other ways to manage the cost of education. In family situations where need-based financial aid isunlikely , it is important to attempt to utilize your child's tax capacity —the lower tax bracket and ability to benefit from education credits that are otherwise unavailable to the parents, due to income phase-outs—to cut the family's total tax bill. These strategies will differ depending upon the method the family is using to fund higher education for a child.

Some questions to ask yourself that will determine your ability to realize tax savings by utilizing your child's tax capacity include:

- Is your child subject to the "kiddie tax" rules? If so, his or her unearned income (i.e., interest, dividends, and capital gains) in excess of $2,000 (for 2014) will be taxed at the parents' highest marginal tax rate (if it is higher than the tax rate the child would have otherwise incurred). The kiddie tax rules apply to:
    - children who have earned income that is less than or equal to 50% of their support and are either:
        - age 18,
        - (b) a full-time student age 19–23, as well as
    - children under age 18, regardless of their earned income level.
- Is your child still a dependent? If so, the education credits may not be available to them. A student under age 24 who does not provide over half of his or her own support considered to be their parent's dependent. For purposes of the support test, assets owned by your child (assumed acquired from prior gifts)

> that are used to fund college educational costs qualify as support provided by your child, paid on his or her own behalf. If such expenditures represent over half of the child's support, the child is **not** considered to be the parent's dependent. IRS rulings suggest that gifts are counted as an item of support in determining dependency status for the year in which the gift is made, unless there is proof that the gift was invested, rather than expended on living costs.

Although a number of the rules and requirements for the American Opportunity Tax Credit (AOTC) and Lifetime Learning Tax Credit (LLTC) are identical, the taxpayer can only elect to claim one of the credits in a tax year for the same student. However, this does not prevent a taxpayer from claiming different credits (or the same credit) for different students during a tax year. For 2014, the LLTC phases out ratably as modified AGI (MAGI) moves from $108,000 – $128,000 for married-joint filers and $54,000 – $64,000 for other taxpayers. For the AOTC, the phase-out range is $160,000 – $180,000 for married-joint filers and $80,000 – $90,000 for other taxpayers. The LLTC phase-out ranges are indexed for inflation while the phase-out ranges for the AOTC are not. In most cases, it will be more beneficial to use the AOTC (if eligible), as opposed to the LLTC, since it will yield a greater tax benefit.

If the parents own their own business and are in a higher income tax bracket than their child, a strategy to utilize could be to employ their child or children in their business. Not only will this provide the parents with a tax deduction but will also provide the student with earned income to utilize toward his or her own support. This could potentially qualify the student for the AOTC or the LTLC. It should be noted, however, that the employed children must earn their wages, and cannot be simply paid by the business without actually performing work for the business. They must also be paid an appropriate wage for the tasks they perform.

If you claim your child as a dependent, your child cannot claim an education credit for that tax year for their qualified tuition and related expenses. If, however, you are eligible to claim your child as a dependent and don't, then **only** your child may claim the education credit for their qualified tuition and related expenses. Any qualified tuition and related expenses paid by your child, who you have claimed as a dependent, can be treated as paid by the parents for the tax year in which the expenses are paid.

The ability for you to shift the education credit to your child by simply not claiming your child as a dependent on your return (even though you are eligible to) is particularly beneficial to high-income taxpayers. This allows parents who cannot benefit from the education credit because their AGI is too high to shift the credit to their child or children, regardless of whether the child or the parents pay the education costs.

Forty percent of the AOTC is refundable for most taxpayers. However, if you are under age 24 at the end of the year and the conditions listed below apply to you, you cannot claim any part of the American opportunity credit as a refundable credit on your tax return. Instead, your allowed credit will be used to reduce your tax as a nonrefundable credit only.

You do not qualify for a refundable credit if items 1 (a, b, or c), 2, and 3 below apply to you.

1) You were:
    a. Under age 18 at the end of the year, or
    b. Age 18 at the end of the year and your earned income was less than one-half of your support, or
    c. Over age 18 and under age 24 at the end of the year and a full-time student and your earned income was less than one-half of your support.
2) At least one of your parents was alive at the end of the year.
3) You are filing a return as single, head of household, qualifying widow(er), or married filing separately for the year.

It should be noted, however, that parents choosing to not claim the child as a dependent does not automatically enable the child to claim their own dependency exemption on their own return. The fact that the parents are eligible to claim the dependency exemption for the child (regardless of whether they actually claim it) prevents the child from claiming it on his or her own return.

When parents hold appreciated long-term capital assets, such as appreciated stocks, they should consider making a gift of the appreciated stock (or other assets such as mutual funds) at least one year in advance of the child's need for funds for higher education. This stock can then be sold during the college years to provide more than 50% of the child's support. In addition, the child can look for employment that will provide more than 50% of his or her support. This earned income may have the added advantage of keeping the child from being subject to the kiddie tax rules. To avoid kiddie tax, the child's earned income must exceed 50% of his or her support. The gains the child recognizes each year should be planned to efficiently utilize the child's LLTC and/or AOTC.

A child's tax capacity is maximized when he or she is neither a dependent nor subject to kiddie tax. Avoiding treatment as a dependent not only allows the child to claim the personal exemption, it also allows the child a greater standard deduction and the ability to claim education credits. Avoiding the kiddie tax allows the child to take full advantage of the 0%, 10%, and 15% tax brackets, as well as claim the refundable portion of the AOTC.

For more information on effective tax planning to offset the costs of higher education, contact one of the tax professionals at Zinner & Co. LLP.