LET THE IRS PAY FOR COLLEGE!

Small business owners can often combine employment of their children (or grandchildren) with Roth IRA funding to create substantial college education funds - with the IRS picking up much of the tab!

This strategy works with all types of business tax structures, including S Corporations, LLC's, sole proprietorships, etc. You must be able to justify that the amount of wages paid to your child/children is "fair" in light of the services they provide to your business. Brainstorm a list of job tasks which your child can perform that provide value to your business and then place "dollar values" on those tasks.

A CASE STUDY

The simple case study below lays out a typical fact pattern:

1. You own a small business.
2. You are in the 35 percent tax bracket (combined federal and state income taxes).
3. Your daughter/son is age 7 this year.
4. You pay your son/daughter (or both!) $5,000 for work she/he does in your business this year and each year for the next 11 years until she/he turns 18.
5. Your child puts the $5,000 into a Roth IRA each year for the next 11 years. (They qualify to fund a Roth since they have wage income.)

THE RESULTS

1. You pay your child $5,000, deduct $5,000 as a business expense, and save $1,750 of income tax.
2. Your child collects the $5,000 of income and owes zero Federal income tax because of the standard deduction.
3. Because the $5,000 was not taxable to your child, the full $5,000 is invested in a Roth IRA.

At this point, the government has paid you $1,750 to put $5,000 into your child's Roth IRA, which is going to become part of his/her college fund.

11 YEARS LATER

So, here we are 11 years later. For each of the 11 years, your child invested his/her tax-free earnings in a Roth IRA that earned an average return of 5 percent a year. **The Roth IRA has a value of $74,785 when your child turns 18**. You have invested your payroll tax deductions/savings in your business, or some other manner and earned an after-tax return of 5 percent a year, giving you $24,862.

In essence, the government paid you $24,862 so you could help your child accumulate a $74,785 college fund nest egg!

OFF TO COLLEGE

Some colleges and universities (mostly private) treat a Roth IRA as an asset that can reduce student aid. But a much larger number of colleges and universities use the federal student aid form (FAFSA), which does not count the Roth IRA as an asset in determining college aid.

Thus, for your child's freshman year, she/he can look for college financial aid at institutions that do not consider the Roth IRA an asset.

Alternatively, if your child will not qualify for student aid because you have too many assets or your income is too high, you and your child will have your government-subsidized Roth IRA ready to help pay for college education costs!

RULES TO REMEMBER

There are three tax rules that you should know regarding your child's early withdrawal of Roth IRA funds to pay for college:

1. Early distributions from a Roth IRA are subject to a 10 percent penalty tax; however, an **early distribution escapes the penalty tax to the extent your child incurs qualified higher education costs for the year.**
    - **Example:** Your child withdraws $10,000 from the Roth IRA and incurs $20,000 of qualified higher educational costs for the year. No 10% penalties are imposed because the educational costs of $20,000 exceed the $10,000 Roth IRA withdrawal.
    - On the other hand, say your child withdraws $30,000 from the Roth IRA and incurs $20,000 of qualified higher educational costs for the year. A 10 percent penalty tax of $1,000 will be owed on the excess.
2. The Roth IRA distribution rules say that your child's **withdrawal first comes from the invested basis in the Roth**. In this case, the $55,000 (11 years at $5,000 per year) invested. (Keep in mind that this is the $55,000 you deducted as a wage and on which your child paid zero federal income taxes.)
3. The monies your child withdraws in excess of the $55,000 basis are from earnings that took place inside the Roth. **The inside earnings withdrawn for college are subject to income taxes at your child's then tax bracket**.

PLANNING NOTE

Your child could easily be in the zero income-tax bracket for the first withdrawals of taxable money because of the standard deduction (currently $5,950). Then after the use of the standard deduction, the Roth income is taxed at starting rates of 10%. Planning can reduce or eliminate income tax on the Roth distributions used for college costs.

NOTE TO GRANDPARENTS

The exact same "payroll/Roth IRA" college planning strategy can be used by grandparents who own businesses.

FINAL THOUGHTS

If you plan on using this strategy of putting your children "on the payroll" and the child's federal income tax-free payroll checks are contributed to a Roth IRA account, you should start early! Identify jobs your children can do at younger ages and start the payroll/Roth process early. If you can justify $2,000 of job value at age 6, start with $2,000 and increase the wage as your child can take on increased job responsibilities.

The CPA/CPP team at AccuPay can assist you in using this strategy. **Call us today at 317-885-7600**.

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