Tax savings via education credits. Additional intra-family tax savings in the form of education credits may be available.

For 2010, taxpayers may claim an American opportunity tax credit (AOTC)/Hope scholarship credit equal to 100% of up to $2,000 of qualified higher-education tuition and related expenses plus 25% of the next $2,000 of expenses paid for education furnished to an eligible student in an academic period. Thus, the maximum AOTC) Hope scholarship credit is $2,500 a year for *each* eligible student. (Code Sec. 25A(a)(1), Code Sec. 25A(i)(1))

The AOTC/Hope credit may be elected for a student's expenses for 4 tax years, and only for students who have not completed the first 4 years of post-secondary education as of the beginning of the tax year. (Code Sec. 25A(b)(2), Code Sec. 25A(i)(2))

Subject to an exception, 40% of a taxpayer's otherwise allowable AOTC/Hope credit for 2010 is refundable. No portion of the credit is refundable if the taxpayer claiming the credit is a child subject to the kiddie tax under Code Sec. 1(g) or a resident of a U.S. possessions (who instead claim the credit where they reside). (Code Sec. 25A(i)(6))

Taxpayers may elect a Lifetime Learning credit equal to 20% of up to $10,000 of qualified tuition and related expenses paid during the tax year. The maximum credit for a tax year is $2,000, regardless of the number of students. (Code Sec. 25A(a)(2), Code Sec. 25A(c)(1)) For 2010, the credit is phased out ratably for taxpayers with modified AGI from $50,000 to $60,000 ($100,000 to $120,000 for marrieds filing jointly).

Where a parent pays the college education expenses of a child whom he claims as a dependent, only the parent may claim the education credits (if otherwise eligible). However, if a parent is eligible to but does not claim a student as a dependent, the student may claim the education credit for qualified expenses paid by him or the parent. (Reg. § 1.25A-1(f)(2), Ex. 2; IRS Publication 970, 2009, pg. 15)

> **RIA recommendation:** It may pay for a parent not to claim the student as a dependent if (1) the parent can't claim education credits because of high modified AGI, and (2) the student pays or is deemed to pay the expense and has sufficient tax liability (e.g., from summer or part-time employment) to claim the credit.

> **RIA illustration:** Mr. and Mrs. Green have AGI of $250,000 and are in the 33% bracket. For 2010, claiming their college-freshman son as a dependent would save $1,204.50 in taxes (33% of $3,650 dependency exemption for the son). The Greens spend $24,000 on the son's AOTC/Hope-credit-eligible qualified tuition, and the son has $10,000 of taxable income from his salary working for the family business. The Greens can't claim an education credit for their child because of their high income and would be better off not claiming their son as a dependent. This way, the son may completely eliminate his $1,081.25 tax liability (10% of $8,375 taxable income, plus 15% of the $1,625 balance). He also may claim a refund for another $1,000 of the AOTC/Hope credit (40% of $2,500), so the total credit (and total savings to the child, is $2,081.25, versus the $1,204.50 the Greens would save if they claimed their son as a dependent.

> **RIA caution:** If a parent is eligible to claim child as a dependent but doesn't, the child still cannot claim an exemption for himself.

Income tax withholding. Regardless of how the family business is organized, it probably will have to withhold federal income taxes on the child's wages. Usually, an employee who had no federal income tax liability for the prior year, and expects to have none for the current year, can claim exempt status. However, exemption from withholding can't be claimed if (1) the employee's income exceeds $750 and includes more than $250 of unearned income (such as dividends), and (2) the employee may be claimed as a dependent on someone else's return (whether or not he actually is claimed). (Instructions to Form W-4 for 2010) Keep in mind that the child probably will get a refund for part or all of the withheld tax when he or she files a return for the year.

FICA and FUTA. Employment for FICA tax purposes doesn't include services performed by a child under the age of 18 while employed by a parent. (Code Sec. 3121(b)(3)(A)) This can generate some savings for a parent who runs an unincorporated business. For example, let's say a sole proprietor who usually takes $120,000 of earnings from the business pays $4,750 to her 17-year-old child in 2010. The sole proprietor's self-employment income would be reduced by $4,750, saving her $137.75 (the 2.9% HI portion of the self employment tax she would have paid on the $4,750 shifted to her child). This doesn't take into account a sole proprietor's income tax deduction for one-half of his or her own social security taxes. That's on top of the $363.37 (.0765 × $4,750) in employee FICA that the child saves by working for Mom instead of someone else. A similar but more liberal exemption applies for FUTA, which exempts earnings paid to a child under age 21 while employed by his or her parent. The FICA and FUTA exemptions also apply if a child is employed by a partnership consisting solely of his parents.

However, there is no FICA or FUTA exemption for employing a child in an incorporated business or in a partnership that includes non-parent partners. The children are subject to the same rules that apply to all other employees.

> **RIA caution:** The Hiring Incentives to Restore Employment Act (HIRE Act, P.L. 111-147) carried two valuable incentives for employers that boost payroll this year: a payroll tax holiday for employers that hire unemployed workers; and an up-to-$1,000

tax credit for keeping such new hires on the payroll for at least one year. Neither of these tax breaks is available for hiring a child (see Federal Taxes Weekly Alert 05/06/2010).