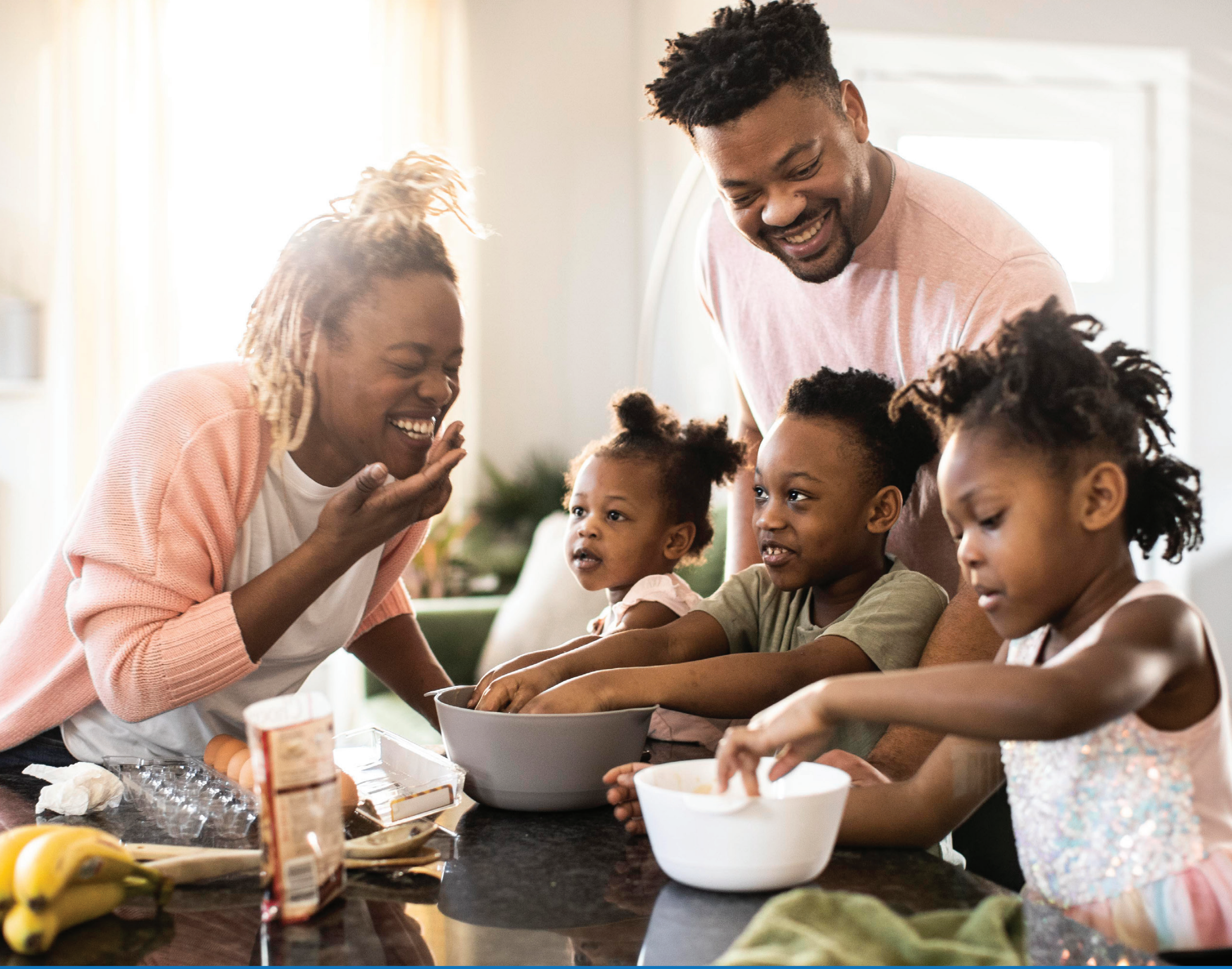

Tax strategies for families with children

TAX YEAR 2021

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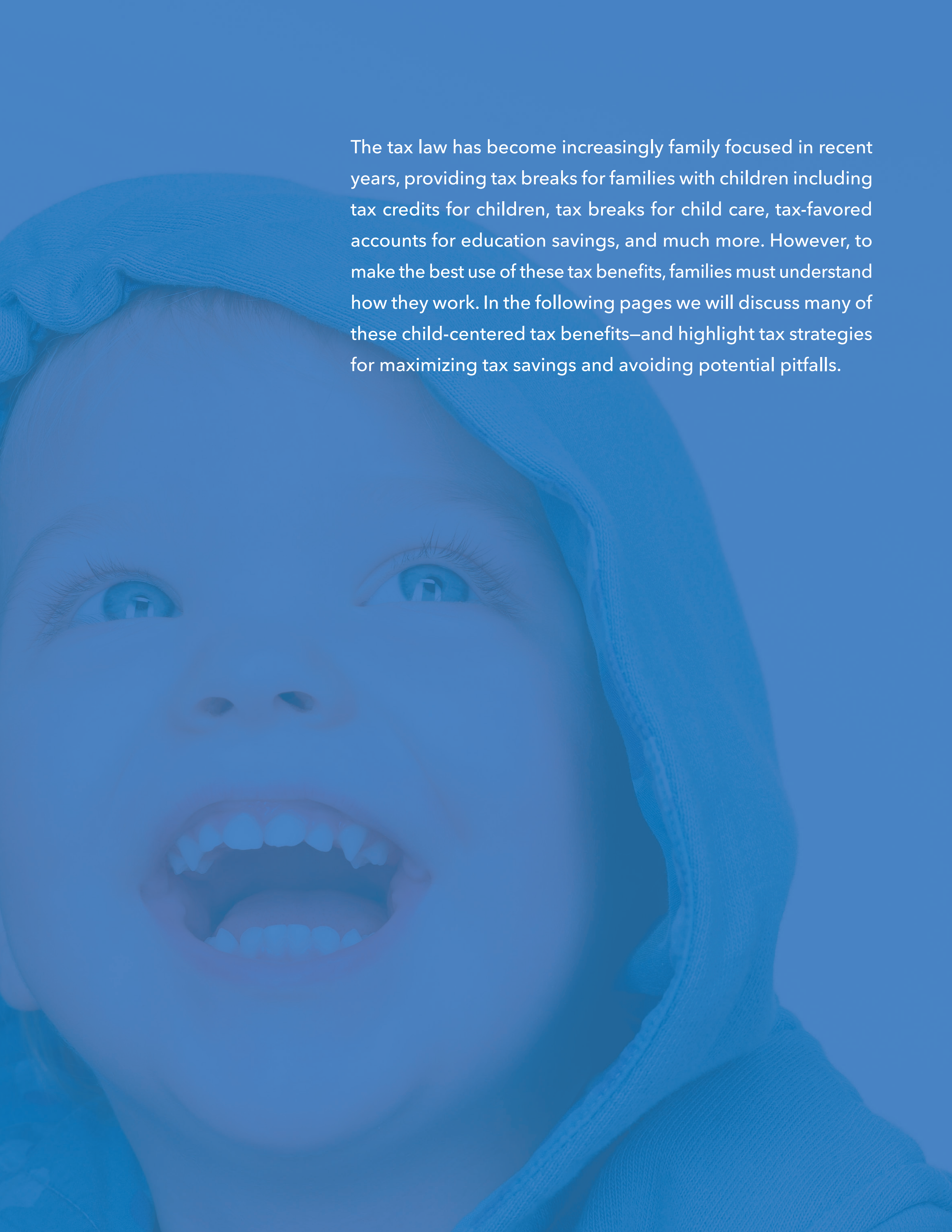
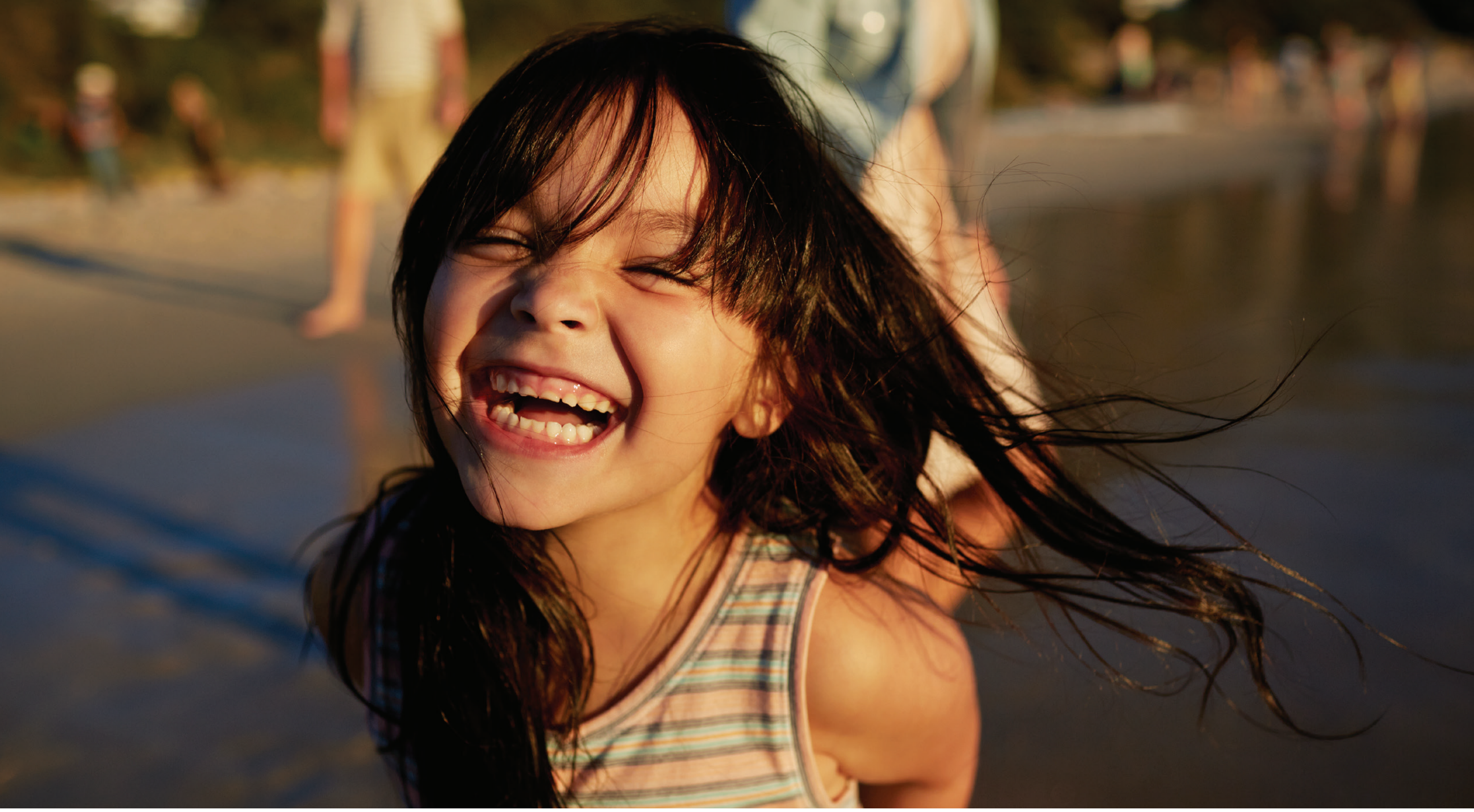
The tax law has become increasingly family focused in recent years, providing tax breaks for families with children including tax credits for children, tax breaks for child care, tax-favored accounts for education savings, and much more. However, to make the best use of these tax benefits, families must understand how they work. In the following pages we will discuss many of these child-centered tax benefits—and highlight tax strategies for maximizing tax savings and avoiding potential pitfalls.





Child Tax Credit

Under the current tax law, an individual taxpayer generally can claim a maximum child tax credit of $2,000 for each qualifying child under age 17 (Code Sec. 24(h)(2)). For lower income taxpayers, the child tax credit is generally partially refundable to the extent of 15% of earned income above $3,000 up to $1,400 per child (Code Sec. 24(h)(5)). For higher income taxpayers, the credit is phased out if income exceeds $400,000 on a joint return or $200,00 on another return (Code Sec. 24(h)(3))

Special rules for 2021. In response to the COVID-19 pandemic, the American Rescue Plan Act expanded the child tax credit for 2021 (Code Sec. 24(i)). The amount of the credit was increased from $2,000 per child to $3,600 for children under age 6 as of the close of the tax year and to $3,000 for other qualifying children. In addition, the definition of a qualifying child was temporarily broadened to include a child who has not turned age 18 by the end of 2021.

The expanded credit is subject to a phase out for taxpayers with incomes above $75,000 for singles, $112,5000 for heads of households and $150,000 for joint filers. However, the phaseout applies only to the increased credit amounts—that is, $1,600 for children under 6 and $1,000 for other children—and not to the $2,000 regular child tax credit. The regular phaseout rules apply to the $2,000 amount.

The credit is generally fully refundable for 2021. Moreover, the laws directed the IRS to make advance payment of 50% of a taxpayers estimated child tax credit for 2021, unless a taxpayer elected out of the advance payments.

Tax strategies. Advance payments of the child tax credit were generally calculated based on child tax credits claimed on a taxpayer's 2020 return (or 2019 if the 2020 return was not filed by the time advance payments began in July of 2021). Therefore, taxpayers will have to reconcile their advance payments with their actual child tax credits for 2021. The credit claimed on the 2021 return must be reduced by advance payments received during the year.

If the amount of the allowable 2021 child tax credit exceeds the amount of advance child tax credits received, the taxpayer can claim the remaining amount on the 2021 return. For example, if the number of eligible children has not changed, the taxpayer will claim the additional 50% of the allowable credit on the 2021 return. Similarly, if a taxpayer added a dependent child for 2021, the taxpayer will claim the full amount of the credit for that child on the 2021 return.

On the other hand, in some cases, the advance child tax credit payments may exceed the allowable credit for 2021—for example, due to changes in the number of qualifying children, changes in income, or changes in filing status. In that case, the taxpayer may have to repay all or a portion of the advance child tax credit payments by reporting the excess as income on the 2021 return. However, the law provides repayment protection for some taxpayers. If modified adjusted gross income does not exceed 200% of an applicable income threshold, the amount of the increase in tax due to the advance payments will be reduced by a safe harbor amount. The applicable income thresholds are $60,000 for a joint return or surviving spouse, $50,000 for a head of household, and $40,000 for other taxpayers. The safe harbor amount is $2,000 multiplied by the excess (if any) of the number of qualified children taken into account in determining the advance amount over the number of qualified children taken into account in determining the allowable credit for the tax year.

Taxpayers should also bear in mind that the expanded child tax credit and advance payment provisions are temporary tax breaks for 2021 only. Therefore, in calculating estimated tax liabilities for 2022, the general tax child tax credit rules will apply.

Child and Dependent Care

The tax law provides two basic tax breaks for working parents with children:

- A child and dependent care tax credits for expenses paid to allow the taxpayer to work
- An exclusion from gross income for employer-provided dependent care assistance

Child and Dependent Care Tax Credit

A taxpayer can claim an income tax credit for child and dependent care expenses for a qualifying individual that allow the taxpayer to be gainfully employed or to actively search for gainful employment (Code Sec. 21). Under general tax law rules, the credit is nonrefundable.

A qualifying individual is:

- A dependent child under age 13;
- a dependent who is physically or mentally incapable of self-care and who has the principal place of abode as the taxpayer for more than one-half the tax year; or
- the taxpayer's spouse who is physically or mentally incapable of self-care and who has the principal place of abode as the taxpayer for more than one-half the tax year.

The credit is 35% of employment-related expenses incurred by taxpayers with adjusted gross income (AGI) of $15,000 or less. The percentage decreases by 1% for each $2,000 (or fraction of that amount) of AGI over $15,000, but not below 20%. Thus, for taxpayers with AGI over $43,000, the applicable percentage is 20%.

In the case of a taxpayer who is unmarried at the close of the tax year, the amount of employment-related expenses that can be taken into account cannot exceed the taxpayer's earned income. If a taxpayer is married at the close of the tax year, employment-related expenses cannot exceed the lesser of the taxpayer's earned income or the earned income of the taxpayer's spouse. For this purpose, a spouse who is a full-time student or who is incapable of self-care is deemed to have earned income of $250 per month if there is one qualifying individual or $500 per month if there are two or more qualifying individuals.

Qualifying expenses include expenses for household services and for care of the qualifying individual. Payments for services outside the taxpayer's household qualify only if incurred for a dependent under age 13 or another qualifying individual who regularly spends at least eight hours each day in the taxpayer's household.

The credit is allowed to married taxpayers only if they file a joint return. However, a married individual living apart from his or her spouse can claim the credit on a separate return if he or she (1) maintains a household that is the principal place of abode of a qualifying individual for more than half of the tax year and from which the other spouse is absent for the last six months of the tax year and (2) furnishes over one-half the cost of that household for the tax year.

Special rules for 2021. As with the child tax credit, the American Rescue Plan Act expanded the child and dependent care credit for tax year 2021. (Code Sec. 21(g) The dollar limit on the amount of employment-related expenses is increased from $3,000 to $8,000 if there is one qualifying individual and from $6,000 to $16,000 if there are two or more qualifying individuals. In addition, credit percentage is increased from 35% to 50%, reduced by 1% for each $2,000 (or fraction thereof) of adjusted gross income above $125,000 up to $185,000. For taxpayers with adjusted gross income of more than $185,00 but less

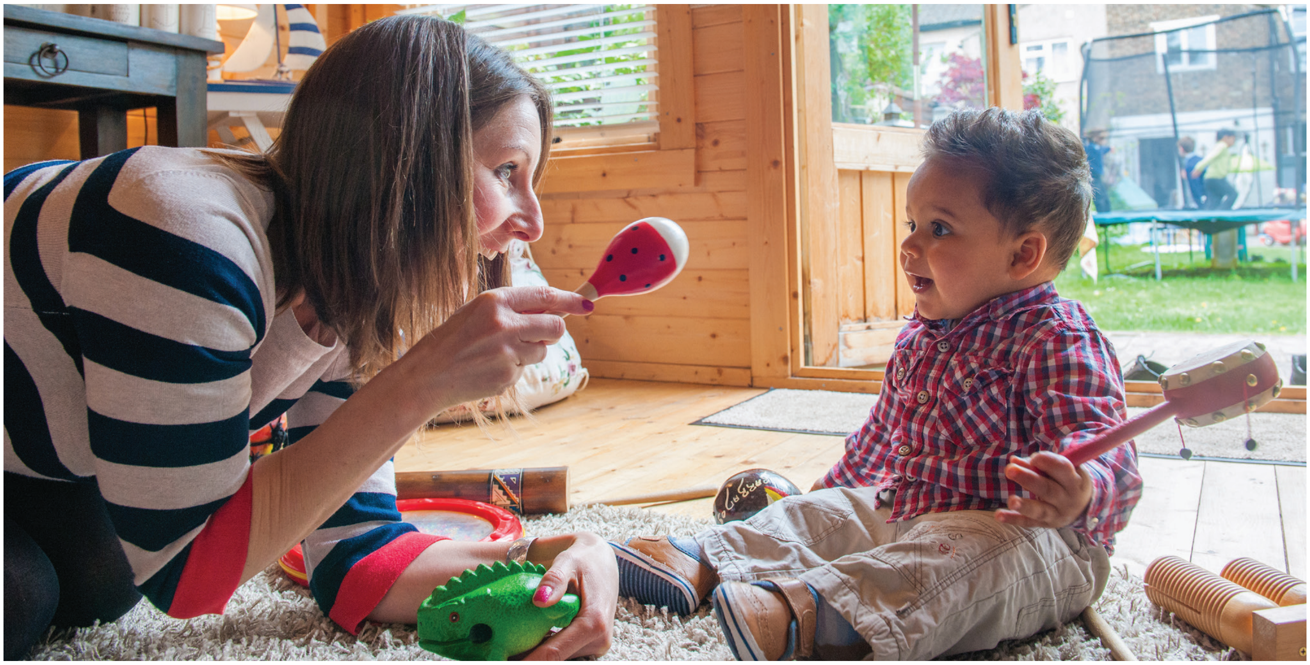
than $400,000, the credit percentage is 20%. For taxpayer with adjusted gross income of more than $400,000, the credit percentage is decreased by 1% for every $2,000 of adjusted gross income above $400,000. Thus, the credit is completely phased out for taxpayers with adjusted gross income of more than $438,000. For 2021, the credit is refundable for taxpayers with a principal place of abode in the U.S. for more than half the tax year. On a joint return, one spouse must meet that requirement.

Dependent Care Assistance

The tax law provides an exclusion from gross income for amounts provided to an employee under an employer's dependent care assistance program (DCAP). (Code Sec. 129) Under longstanding rules, up to $5,000 ($2,500 if the employee is married and files a separate return) of employer-provided dependent care assistance can be excluded from an employee's income each year. However, the exclusion cannot exceed the employee's earned income or, for married employees, the earned income of the lower earning spouse. As with the child and dependent care credit, a spouse who is incapacitated or who is a full-time student for at least five months during the calendar year is treated as having earned income of not less than $250 per month if there is one qualifying dependent and not less than $500 per month if there are two or more qualifying dependents. The maximum exclusion is not, however, limited based on adjusted gross income.

Amounts excluded from income are not subject to Social Security and Medicare (FICA) tax, federal unemployment (FUTA) tax, or federal income tax withholding.

DCAP benefits may be provided by a flexible spending arrangement (FSA) under a cafeteria plan, allowing an employee to contribute to the DCAP through salary reduction contributions with the DCAP reimbursing the employee for dependent care expenses incurred during the year. (Code Sec. 125) As a general rule, DCAP benefits funded through an FSA are a use-it-or-lose it proposition; benefits remaining at the end of the plan year may be used during a 2½ month grace period following the end of the plan year but cannot be carried over. Reimbursements of dependent care expenses are excluded from gross income. However, reimbursements that are not for qualifying expenses are included in an employee's gross income and wages.



Contributions to an FSA are made on a pre-tax basis and are not subject to Social Security and Medicare (FICA) tax, federal unemployment (FUTA) tax, or federal income tax withholding.

Special rules for 2021. For 2021, the American Rescue Plan Act permitted but did not require employers to increase the maximum DCAP exclusion to $10,500 (5,250 for marrieds filing separately). (Code Sec. 129(a)(2)(D)) In addition, the law allows DCAPs to be amended to permit employees to carry over unused benefits from 2020 to 2021 and from 2021 to 2022, even though DCAPs do not generally allow carryovers. Alternatively, a DCAP can extend the grace period or claims for the 2020 or 2021 plan year to 12 months after the end of the plan year.

Tax strategies. An employee who receives employer-provided dependent care assistance is not automatically barred from claiming an individual tax credit for dependent care expenses. However, the same expenses cannot be taken into account for both benefits. In addition, benefit payments received under a DCAP reduce the amount of expenses that may be taken into account in computing the federal income tax credit for dependent care expenses on a dollar-for-dollar basis. Consequently, under general tax rules, employees who receive DCAP benefits may receive little or no tax benefit from the credit. For example, in the case of an employee with one qualifying individual, the maximum $5,000 DCAP benefit will completely eliminate the $3,000 of expenses that may be taken into account for the credit. Similarly, an employee who receives the maximum DCAP will have allowable expenses for the credit reduced to $1,000 ($6,000 allowable expenses less $5,000 DCAP).

On the other hand, employees who have been locked out of the child and dependent care credit in prior years should take a second look for 2021—especially if their employees did not raise the cap on DCAP benefits. For example, and employee who received the traditional $5,000 DCAP benefit for 2021 can potentially claim the credit for an additional $3,000 of expenses ($8,000 expense limit for 2021 less $5,000 DCAP).

Employees who must make a choice between a DCAP and the child and dependent care credit may get a bigger bang for their buck with the DCAP. Expenses for which the credit is claimed must be paid with dollars that are subject to FICA and FUTA taxes, while DCAP funds are not subject to FICA or FUTA taxes.

Taxpayers who employ household workers for child and dependent care should factor an additional cost into their tax planning—the so-called...

Nanny tax. A taxpayer must generally withhold and pay Social Security and Medicare (FICA) taxes for a household employee if the taxpayer has paid the employee cash wages equal to or more than a threshold amount for the year. (Code Sec. 3121(a)(7)(B)) The threshold amount is $2,300 for 2021. The taxpayer must pay federal unemployment tax (FUTA) for a household employee if the taxpayer paid aggregate cash wages of $1,000 or more to the employee in any calendar quarter of the current or preceding calendar year. (Code Sec. 3306(c)(2).

Income tax withholding may be required depending on the amount paid to the employee and the employee's marital status, number of dependents, and other factors. Form W-4, *Employee's Withholding Certificate*, should be completed by the employee to determine required withholding

The taxpayer must report and pay the employment taxes for household employees on Schedule H, *Household Employment Taxes*, which is filed with the taxpayer's Form 1040 individual income tax return. The taxpayer must provide the employee with a Form W-2, *Wage and Tax Statement*, on or before January 31 of the year following the year in which the wages were paid and file Form W-3, *Transmittal of Wage and Tax Statements*, with the Social Security Administrations. The taxpayer will need an Employer Identification Number (EIN) to prepare and file Form W-2. An EIN can be obtained by filing Form SS-4 with the IRS.

Tax strategies. Because the nanny tax is reported and paid with the taxpayer's individual income tax return, it is considered part of the taxpayer's tax liability for the year. Therefore, the taxpayer should increase either estimated tax payments or income tax withholding on his or her wages to cover the tax. Failure to do so could result in estimated tax penalties.

Other Tax Credits

Two other tax credits may be beneficial to families with children in certain circumstances.

Adoption Credit. Adoptive parents may claim an income tax credit for qualified adoption expenses for an eligible child. (Code Sec. 23). An eligible child is a child under 18 at the time the expenses are paid or an individual incapable of self-care. The credit is subject to a phase-out for higher-income taxpayers. The maximum credit and the phase-out threshold are subject to annual inflation adjustments.

The maximum credit is $14,440 for 2021, for both special needs and non-special needs adoptions. In the case of the adoption of a child with special needs, the maximum credit is allowable without regard to the actual amount of adoption expenses. For 2021, the credit begins to phase out for taxpayers with modified adjusted gross income over $216,660 and is fully eliminated at modified AGI of $256,660. Married individuals must file jointly to claim the credit.

In the case of a domestic adoption, the credit for an expense paid or incurred before the tax year in which the adoption becomes final is allowed for the tax year following the tax year during which it is paid or incurred. For an expense paid or incurred during or after the tax year in which the adoption becomes final the credit is allowed for the tax year in which the expense is paid or incurred.

The credit for a foreign adoption isn't allowed unless the adoption becomes final. Expenses paid or incurred in the year the foreign adoption is finalized or in an earlier year are allowed in the year the adoption is final; and expenses after the year the foreign adoption becomes final are taken into account when paid or incurred.

Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to, and the principal purpose of which is, the taxpayer's legal adoption of an eligible child.

An employee may exclude adoption assistance provided by an employer for qualified adoption expenses connected with the employee's adoption of a child. (Code Sec. 137) The exclusion for adoption assistance is subject to the same dollar limit and phaseout thresholds as the adoption tax credit. The dollar limit applies to the adoption of each child and is cumulative for all tax years (rather than an annual limit). In the case of an adoption of a child with special needs, the exclusion applies regardless of whether the employee has qualified adoption expenses. A taxpayer can't claim an adoption credit for any employer-paid adoption expenses.

Earned income credit. Lower-income workers can qualify for a refundable earned income credit (EIC). (Code Sec. 32) The amount of the credit depends on the taxpayer's earned income and the number of qualifying children, if any. The credit is calculated as a percentage of an inflation-adjusted earned income level. Generally, earned income includes wages, salaries, and other employee compensation plus net earnings from self-employment. The credit is gradually reduced or phased out above certain income levels. The credit isn't available to a taxpayer with excess investment income.

Credit calculations. The credit rate is 34% for a taxpayer with one qualifying child, 40% for a taxpayer with two qualifying children, and 45% for a taxpayer with 3 or more qualifying children. All credit percentages are applied against the taxpayer's earned income up to a statutory level (as adjusted for inflation). For 2021, the statutory level is $10,640 for a taxpayer with one qualifying child, and $14,950 for a taxpayer with two or more qualifying children.

The maximum amount of the credit for 2021 is $3,618 for taxpayers with one qualifying child, $5,980 for those with two qualifying children, and $6,728 for those with three or more qualifying children.

The earned income credit is phased out by a percentage of the taxpayer's adjusted gross income (or, if greater, earned income) in excess of the statutory phase-out level (as adjusted for inflation). (Code Sec. 32(j)(1)); Code Sec. 32(b)) The statutory phase-out percentages are 15.98% for taxpayers with one qualifying child and, 21.06% for taxpayers with two or more qualifying children. For 2021, the phase-out of the EIC begins at $25,470 for joint filers with one or more qualifying children and $19,520 for others with one or more qualifying children.

Special rules for 2021. A relief provision in the American Rescue Plan Act allows taxpayers to use the greater of earned income for 2019 or 2021 when calculating the EIC for 2021.

The American Rescue Plan Act increased the credit rate, earned income level, maximum credit, phaseout percentage and phase out thresholds for taxpayers with no qualifying children.

Excess investment income. A taxpayer with excess "disqualified" income in the tax year can't claim the earned income tax credit. (Code Sec. 32(i)). Disqualified income is mainly investment income (e.g., interest and dividends). Under prior law, no EIC was allowed if disqualified income exceeded $3,650. A law change made by the American Rescue Plan Act increases the limit on excess investment income to $10,000 for tax years beginning after 2020. The $10,000 amount will be adjusted for inflation after 2021.

Tax Benefits for Education

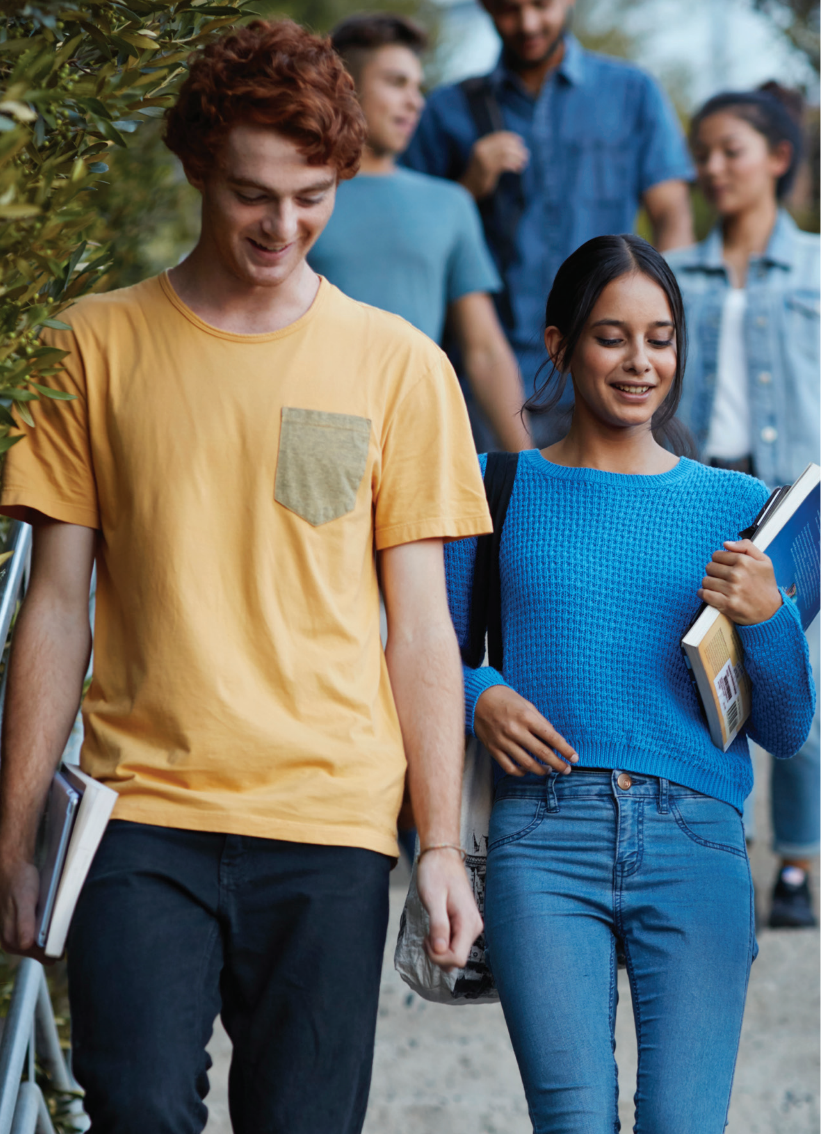
The cost of a child's education can be staggering. Therefore, the key strategies for parents are:

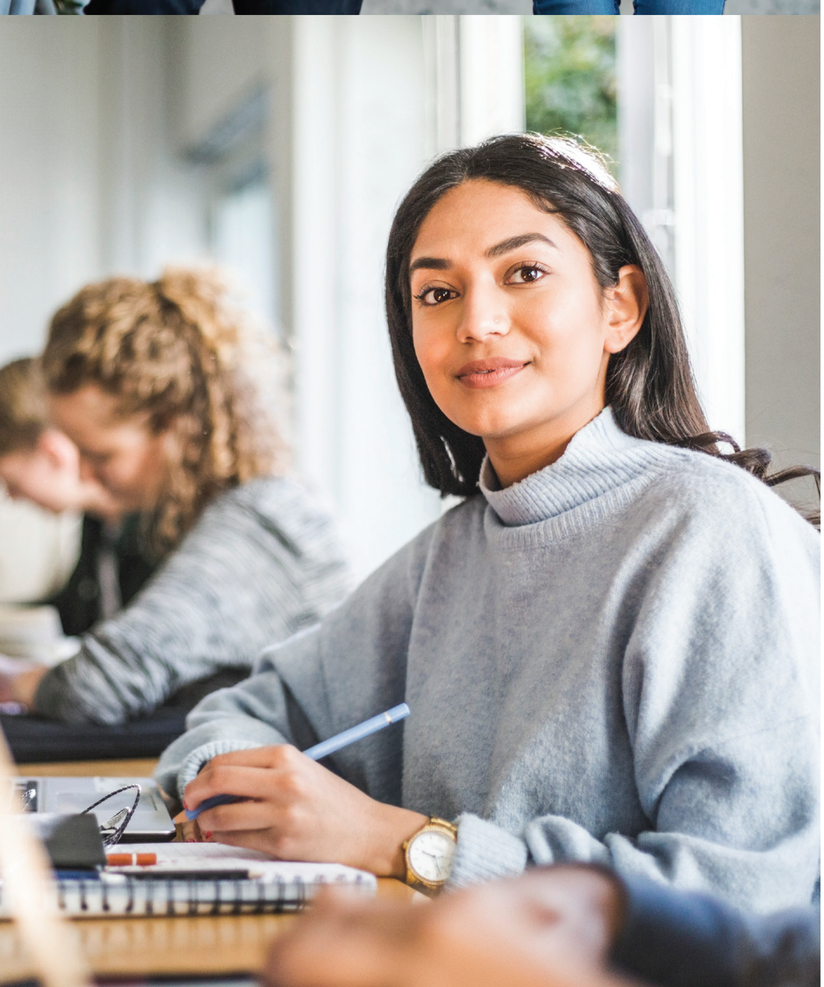
- Save early,
- Save often, and
- Let the savings grow.

in addition, the tax law contains a number of tax benefits for a child's education, ranging from tax-favored savings for a child's education to tax credits for current education expenses, that can help to cut the cost.

Qualified Tuition Programs

A Qualified Tuition Program (QTP)—also known as a Section 529 Plan—allows funds to be set aside either to prepay or contribute to an account for payment of child's qualified education expenses (Code Sec. 529). QTPs are set up and maintained either by states or by eligible educational institutions. However, plans established by educational institutions can only provide for prepayments of a child's expenses. In the case of prepayments, the child will be entitled to a waiver or payment of his or her expenses at that institution.





Contributions to a QTP *are not deductible* for federal income tax purposes. However, distributions from a QTP *are not taxable* so long as the distribution does not exceed the QTP beneficiary's adjusted qualified education expenses. Thus, earnings on QTP contributions grow and compound tax-free. Contributors should bear in mind, however, that investment options in a QTP may be limited.

There are no set dollar limits on contributions to a QTP. However, a QTP must provide safeguards to prevent contributions on behalf of a beneficiary in excess of the amount necessary to provide for the qualified education expenses of the beneficiary. There are no income limits for QTP contributors.

Qualified education expenses are expenses required for enrollment or attendance of the QTP beneficiary at an eligible educational institution. Although typically used for college expenses, a QTP can also be used for qualified elementary and secondary education (kindergarten through grade 12) expenses.

Qualified higher education expenses include tuition and fees, books, supplies, and equipment related to enrollment at college, university, vocational school, or other postsecondary educational institution. Room and board expenses qualify only if a student is enrolled at least half-time—that is, for at least half the full-time academic workload for the course of study the student is pursuing. The costs of a computer, peripheral equipment, software, or internet access count as a qualified expense if the item is to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at a postsecondary institution. Payments of up to $10,000 of principal and interest on a student loan of the QTP beneficiary or the beneficiary's sibling also count as qualified expenses. Moreover, for purposes of the $10,000 limitation, amounts paid for a sibling are taken into account for the sibling and not for the QTP beneficiary.

Qualified elementary and secondary expenses are limited to no more than $10,000 of tuition incurred for the QTP beneficiary in connection with enrollment or attendance at an elementary or secondary school.

As noted above, distributions from a QTP are not taxable to the extent they do not exceed the QTP beneficiary's adjusted qualified education expenses—that is, the amount of total qualified education expenses reduced by any tax-free educational assistance (e.g., tax-free scholarships or grants or employer-provided educational assistance). Any excess distribution is included in income and is generally subject to a 10% additional tax.

QTP assets can be rolled or transferred from one QTP to another. In addition, the designated beneficiary of a QTP can be changed without transferring the account. Amounts distributed from a QTP are not taxable if rolled over to another QTP for the same beneficiary or for a member of the beneficiary's family.

Tax strategies. A QTP doesn't have to be set up in the name of a child beneficiary. A parent—or even a parent-to-be—can set up a QTP in his or her own name and change the beneficiary or roll over the account when the child is ready to head off to school. In addition, QTP contributions are not reserved for parents. Grandparents or other relatives can contribute to a QTP for a child. Contributions to a QTP on are treated as taxable gifts. However, no gift tax return is required for contributions that do not exceed the annual gift tax exclusion ($15,000 for 2021). In addition, if contributions exceed the annual gift tax exclusion, the contributor can make a special election to treat the contribution as made over a five-year period.

Given the high cost of college, QTP funds may be depleted before a beneficiary completes his or her education. However, if there are funds left over when a beneficiary leaves school, there are a number of options including changing the beneficiary to another family member, leaving the funds in the account for possible future education, and using the funds to pay student loans for the beneficiary or a sibling—and, of course, distributing the funds to the beneficiary or QTP owner subject to tax and a 10% penalty.

Coverdell Education Savings Accounts

A Coverdell Education Savings Account (ESA) is a tax-favored education savings vehicle that provides funds for a child's college education, as well as for elementary and secondary schooling (Code Sec. 530).

As with a QTP, contributions to an ESA *are not deductible* but distributions *are not taxable* if used for qualified education expenses.

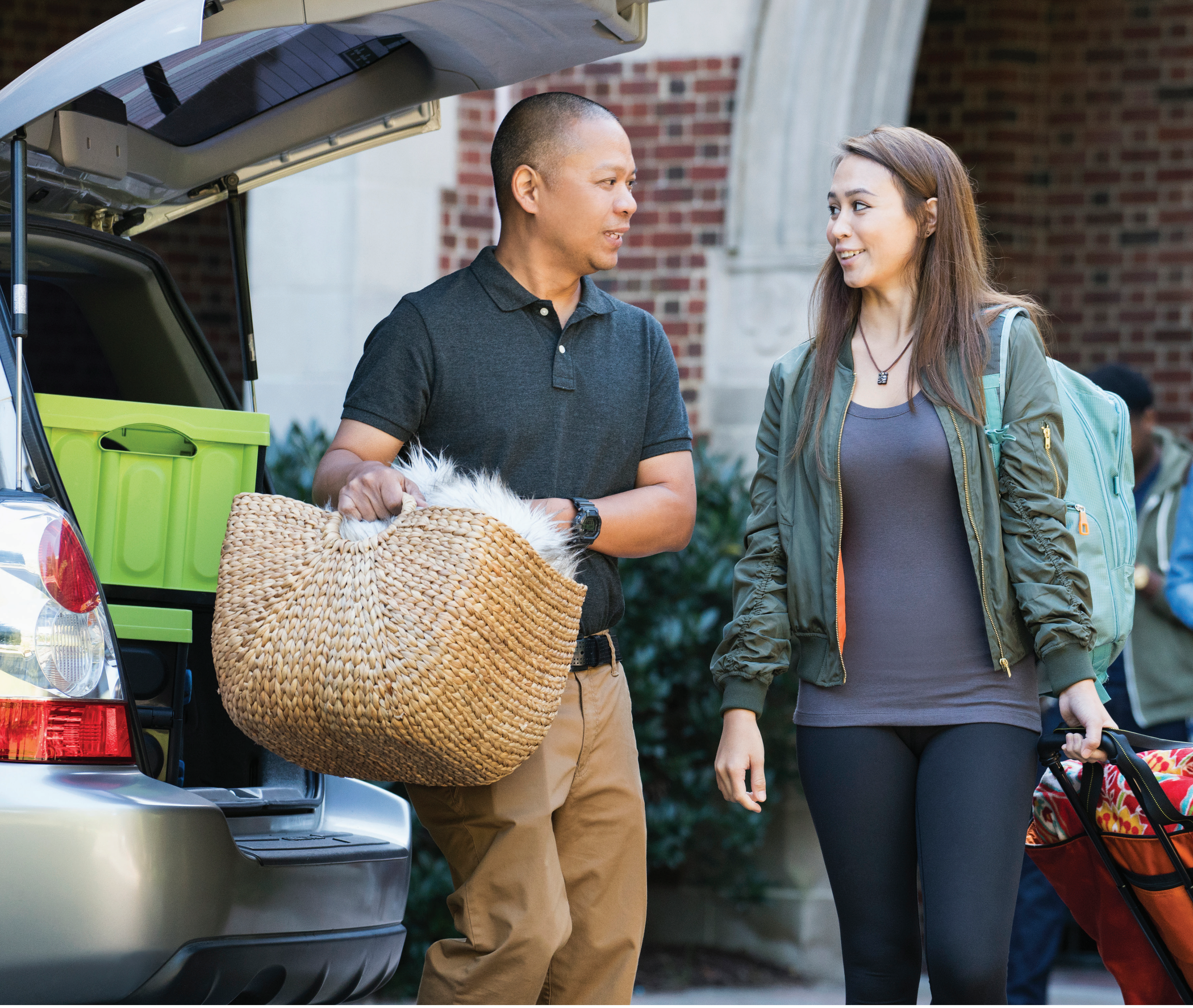
Unlike a QTP, which can be set up for a beneficiary of any age, an ESA can be established only for a beneficiary under age 18. No contributions can be made to the account after the beneficiary reaches age 18. However, the account may remain in existence to pay qualifying education expenses of the beneficiary until he or she reaches age 30. At that time, the balance in the account must be distributed to the beneficiary, unless the balance is rolled over to an account for another eligible beneficiary. If no distribution or rollover is made, the balance of the account is deemed distributed at the end of a 30-day period following the date the beneficiary attains age 30.

ESAs are also subject to dollar limits on contributions and income limits for contributors. Total ESA contributions for a beneficiary cannot be more than $2,000 in any year, including contributions to all of the beneficiary's ESAs from all sources. A 6% excise tax may apply to excess contributions in a beneficiary's ESA at the end of the year (Code Sec. 4973(a)(4)). As a general rule, an individual can contribute the maximum $2,000 to a beneficiary's ESA for a year (assuming there are no other contributors). However, the $2,000 contribution limit is phased out for higher-income individuals and no contributions can by individuals with income of $220,000 on a joint return or $110,000 on any other return. The phase out does not apply to contributions by organizations such as corporations or trusts.

As with a QTP, ESA distributions for a tax year are tax-free to the extent the total does not exceed the beneficiary's adjusted qualified education expenses for the year. However, there are some differences in allowable qualified expenses. Qualified higher education expenses generally mirror those for a QTP. However, qualified elementary and secondary education expenses are defined more broadly to include tuition and fees, as well as books, supplies and equipment, academic tutoring, and special needs services. Qualifying expenses also include room and board, uniforms, transportation, and supplementary items and services (including extended day programs) required for attendance. The costs of computer equipment, software and internet access are qualified expenses if the items are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school.

An excess distribution is included in income and is generally subject to a 10% additional tax. However, a distribution can be rolled over tax-free into another ESA for the same beneficiary or for a member of the beneficiary's family who is under age 30 (or a special needs beneficiary). The designated beneficiary can be changed to another eligible family member without transferring the account.

In addition, contributions to a QTP on behalf of the ESA beneficiary are qualified education expenses that will shelter a distribution from tax. Therefore, ESA funds can effectively be rolled over into a QTP.



Tax strategies. Because of the contribution and contributor limits, an ESA may not be the preferable vehicle for college savings. On the other hand, an ESA may have an edge over a QTP when saving for pre-college expenses because of the broader definition of those qualified elementary and secondary education expenses. Moreover, any leftover ESA funds can be shifted to a QTP for post-secondary expenses.

However, parents or other contributors do not have to choose. A child may be the beneficiary of both a QTP and an ESA. If a designated beneficiary receives distributions from both a QTP and an ESA in the same year, qualified expenses must be allocated between the accounts to determine if any portions of the distributions are taxable.

Education Tax Credits

The tax law provides two tax credits to offset the cost of higher education: the American Opportunity Credit and the Lifetime Learning Credit (Code Sec. 25A).

American Opportunity Credit. The American Opportunity Credit can be claimed for the first four years of an eligible student's post-secondary education. An eligible student may be the taxpayer, the taxpayer's spouse or a dependent claimed on the taxpayer's return.

The credit is allowed for a year if the student was enrolled for at least one academic period in a program leading to a degree, certificate, or other recognized academic credential and carried at least one-half the normal workload for his or her course of study. As a general rule, the credit can be claimed for each of a student's freshman through senior years of college. However, if a student takes more than four years to graduate, the credit can be claimed only for the first four years of attendance.

The maximum annual credit is equal to 100% of the first $2,000 of qualified education expenses paid for an eligible student and 25% of the next $2,000 of eligible expenses paid for that student—for a maximum annual credit of $2,500. The credit is a per-student credit—thus, it can be claimed for each eligible student for whom qualified expenses were paid. The credit is phased out for taxpayers with $160,000 to $180,000 of modified adjusted gross income on a joint return or $80,000 to $90,000 on another return. However, the credit cannot be claimed on a married filing separately return.

Qualified expenses include tuition, fees, and course materials (books, supplies and equipment needed for the student's course of study), adjusted for tax-free educational assistance.

Up to 40% ($1,000) of the American Opportunity Credit is refundable if the credit exceeds the taxpayer's tax liability for the year. However, the credit is not refundable if the taxpayer is a child subject to the kiddie tax rules (see the discussion of the Kiddie Tax below.) The credit can, however, offset the child's tax liability.

Lifetime Learning Credit. The Lifetime Learning Credit is not limited to expenses for a student's post-secondary education. Moreover, there is no limit on the number of years the credit can be claimed for a student. The credit can be claimed for qualified education expenses required for a course at an eligible educational institution as part of a post-secondary degree program or taken to acquire or improve jobs skills.

The credit is equal to 20% of up to $10,000 of qualified expenses, for a maximum credit of $2,000 per year. However, unlike the American Opportunity Credit, the Lifetime Learning Credit is available on a per-family basis—that is, the maximum credit is $2,000 per return regardless of the number of students with qualifying expenses. The Lifetime Learning Credit is not refundable. The credit phased out at the same income levels as the American Opportunity Credit and cannot be claimed by marrieds filing separately.

Tax strategies. Both the American Opportunity Credit and the Lifetime Learning Credit cannot be claimed for a student in a given year. On the other hand, either (but not both) education tax credits can be claimed for a student in the same year that tax-free distributions are made from a QTP or ESA to pay the educational expenses for the student. However, the same expenses cannot be taken into account for both benefits.

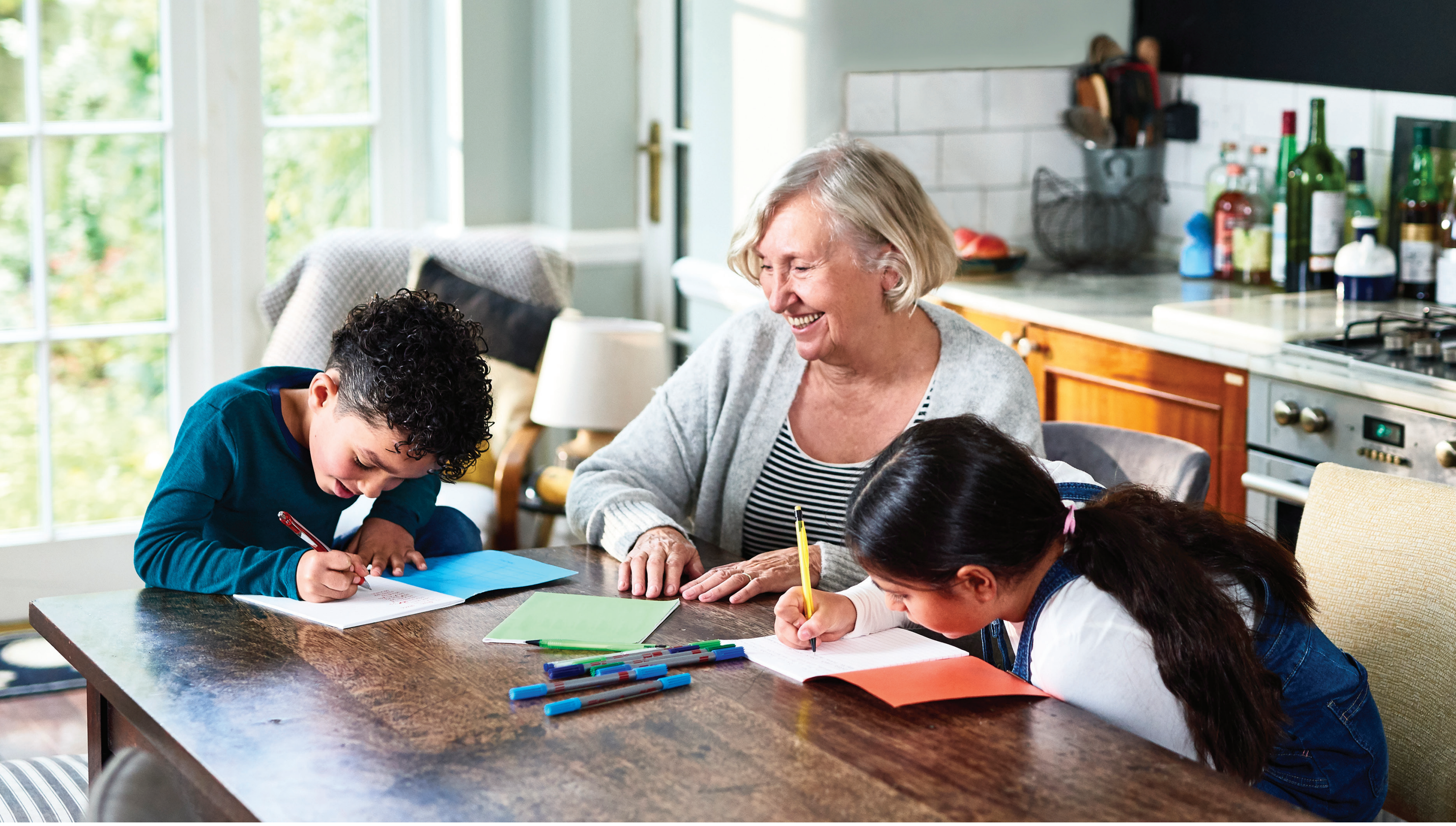
Although QTPs, ESAs, and education credits are not strictly speaking an either-or proposition, let's take a look at how different options stack up on a stand-alone basis.

Example. Jane and John Smith are expecting a child. They anticipate that their offspring will start college in 20 years and want to start saving for his or her college education. They plan to set aside $5,000 a year for the next 20 years--$100,000 total. Assume that the contributions have grown to $200,000 by the time the child starts college and that all of the funds are used for qualified education expenses.

QTP—The Smiths can contribute the full $100,000 to a QTP. Moreover, the earnings on the contributions are not subject to capital gains tax while they remain in the account and are not subject to tax when used for qualified education expenses. Therefore, the Smiths total tax cost is zero and their tax savings equal the $20,000 of capital gains tax that would otherwise be payable on the $100,000 of earnings ($100,000 x 20% capital gains tax rate).

ESA—Of the Smiths' $100,000 of savings only $40,000 can be contributed to an ESA, with the remaining $60,000 in a non-tax-sheltered savings or investment account. Assuming the same growth rate for both accounts, $40,000 of earnings will be tax-free while in the ESA and will be tax-free when distributed for qualified education expenses. However, the Smiths will pay capital gains tax of $12,000 ($60,000 x 20%) on the non-tax-sheltered savings and their total tax savings will equal the $8,000 of capital gains tax that would otherwise be payable on the $40,000 of earnings in the ESA ($40,000 x 20%).

American Opportunity Credit—If the Smiths choose to save outside of a QTP or ESA but claim the American Opportunity Credit for the child's education expenses, their entire $100,000 of earnings will be subject to capital gains tax at a tax cost of $20,000 ($100,000 x 20%). However, that amount will be partially offset by $10,000 of tax savings from the credit ($2,500 per year for four years).



Gift Tax and Kiddie Tax

Parents or other family members may want to transfer cash or other assets to a child to be used for the child's education or to build a nest-egg for the future. If handled carefully, a gifting strategy can cut taxes. However, parents or other donors should be alert to potential consequences of the gift tax and the so-called "kiddie tax."

Gift tax. A gift tax is imposed on any transfer to an individual (other than one's spouse), either directly or indirectly, where full consideration (measured in money or money's worth) is not received in return (Code Sec. 2501). However, there are exclusions that can reduce or eliminate the gift tax.

Annual exclusion: The tax law provides an annual exclusion from gift tax for gifts to any donee during the tax year. The exclusion in indexed annually for inflation. For 2021, the exclusion is $15,000 per donee—or $30,000 for gifts made by a married couple (Code Sec. 2503(b); Code Sec. 2513). There is no limit on the number of donees for whom a donor can claim the annual exclusion or on the number of years it can be claimed.

Tuition or medical expenses. The gift tax does not apply to an amount paid directly to a qualifying educational institution for the donee's tuition (but not for books, room and board or other expenses), In addition, amounts paid directly to a medical provider to cover the donee's medical expense are not subject to gift tax (Code Sec. 2503(e)).

Lifetime exclusion. The tax law provides a combined basic exclusion from estate and gift taxes. For 2021, the exclusion exempts up to $11.7 million of transfers from gift or estate tax. The exclusion is scheduled to drop to $5.49 million after 2025. However, large gifts given before then will qualify for the higher exclusion even if they exceed the exclusion in effect when the donor dies.

Tax strategies. Parents and other family members should strategize gift giving to minimize the gift tax liability—for example, by making large gifts over a period of years to take advantage of the annual gift tax exclusion.

If a gift is intended for a child's college tuition, payments should be made directly to the educational institution to take advantage of the tuition exclusion. Contributions to a child's QTP do not qualify for the tuition exclusion, but do qualify for the annual $15,000 gift tax exclusion. In addition, a donor can elect to treat a larger QTP contribution as made over five years. Thus, a contribution of up to $75,000 in 2021, treated as spread over 5 years, will qualify for exclusion if the election is made.

Kiddie tax. The kiddie tax is designed to prevent parents or other relatives from shifting investment income to a child in a lower tax bracket (Code Sec. 1(g)).

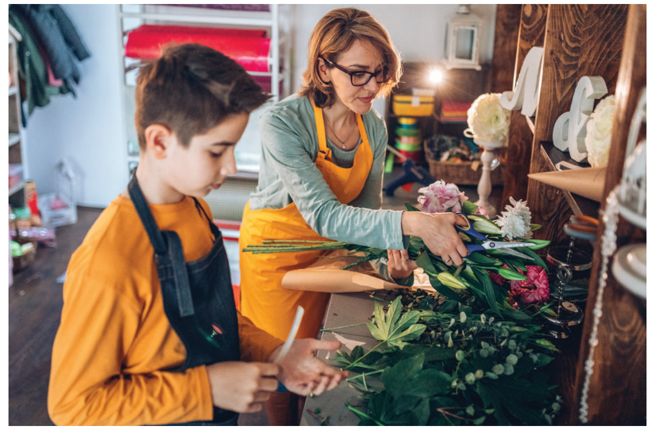
The kiddie tax applies to a child's *net unearned income* if the child (1) is under age 19 or is a full-time student under age 24, (2) has at least one living parent, (3) has unearned income above a threshold amount of $2,200 for 2021 (indexed), and (4) doesn't file a joint return with a spouse for the year. In the case of a child over age 17, the kiddie tax applies only if the child's earned income does not exceed one-half of his or her support.

Under the kiddie tax, a portion of a child's unearned income is tax free, another portion is taxed at the child's income tax rate, and the remaining unearned income is taxed the marginal rate of the child's parents. Thus, for 2021, the first $1,100 of a child's unearned income is not subject to tax, the next $1,100 is tax at the child's rate, and any additional unearned income is taxed at the parents' tax rate (assuming that rate is higher than the child's rate).

Unearned income subject to the kiddie tax includes interest, dividends, capital gains, rents, royalties, taxable scholarships, and the taxable portion of Social Security or pension benefits paid to the child. Earned income that is taxed at the child's rate includes wages, salaries, or other amounts received as compensation for personal services.

Tax strategies. When gifting income-producing assets to a child, donors should consider the amount of income the assets will produce each year to minimize the kiddie tax on unearned income. In addition, since the kiddie tax does not apply to earned income, parents may want to put the child to work. Earnings from a part-time or summer job will be taxed at the child's lower tax rate or may escape tax entirely if sheltered by the standard deduction for dependents (Code Sec. 63 (c)(5)). For 2021, the dependent standard deduction is the greater of $1,100 or earned income plus $350 (but not more than the regular standard deduction for singles of $12,550).

Moreover, for parents with a family-owned business this can be a particularly attractive tax strategy (see below).



Hiring a Child To Work In the Family Business

Payments made by a parent to a child for work in the family business are taxable to the child as earned income. However, if the business is a sole proprietorship or a partnership in which each partner is a parent of the child, payments to a child under age 18 are not subject to Social Security or Medicare (FICA) taxes. Payment to a child under age 21 are not subject federal unemployment (FUTA).

Payments are subject to income tax withholding regardless of the age of the child. The child must complete Form W-4, *Employee's Withholding Certificate*, but may be able to claim exemption from withholding and will not have to file an income tax return if his or her earnings are at or below the dependent standard deduction amount.

On the parent's side, the business can take a deduction for compensation paid to the child, thus shifting income from the parent's rate to the child's lower rate.

Rules to follow. The child must perform actual work for the business, must be paid actual wages, and the parent should keep accurate records of the child's wages. Wages must be at least the minimum wage and reflect local market rates for comparable work.