

Paying for private school

Part I
in a two-part series



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Do your children own your assets? They should!

Are you paying for private K-12 school, expecting to pay for at least some of your children's college bills, and planning to retire? Do the costs seem to be eating you alive? You're not alone! The typical business owner cannot afford to pay for school and retirement without some careful, well-constructed financial planning. This article is the first of a two-part series that will discuss the many strategies available if you are in this situation.

There is no question that private secondary school and college expenses can essentially bankrupt a retirement piggy bank. You might have heard that in order to retire

comfortably 20 years from now, you need to save \$500,000 for every \$1,000 of monthly spending. But, while you are trying to dutifully save for retirement, the costs of education keep rising! The average cost for attending private secondary school is \$14,000 per year, for a public university it is \$15,000, for a private college \$30,000, and for elite colleges it is \$45,000 per year. To make matters worse, because these expenses are paid with after-tax dollars, private secondary schools and colleges cost you much more cash than it appears. As a business owner, you have some unique tools available to pay for private school while spending less money to do so. For the dentist, private

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PAYING FOR PRIVATE SCHOOL

school can be more affordable than ever! Perhaps it's time to check your financial health and begin using a variety of the following strategies:

Children — Employees and salaries

Myth: As a dentist, I cannot pay my children a salary.

• **Fact:** If you own a dental practice, and your children are not on the payroll, not filing tax returns nor taking advantage of the \$5,000 standard deduction for 2005, then your family may be paying too much in taxes! It is estimated that less than 10 percent of dentists use their children as employees in their practices. But it is completely appropriate to pay your children for tasks they are doing for you and the practice.

Myth: My children are really young ... I have no jobs they can do for me.

• **Fact:** In almost every practice, a child can be paid for such tasks as modeling on a brochure (or a friend's brochure), Web site administration, office cleaning, acting as a dental ambassador to schools (especially for pediatric dentists), collating and stamping mass mailings, or yard maintenance. Children may be paid a reasonable salary as compensation for work they do in a practice. In my 30 years in the profession, I have seen clients pay babies for modeling, and then pass an audit when the baby was paid as an employee. Remember, if you are a sole proprietor (or LLC in some states) and you are paying a child under the age of 18, then you do *not* have to pay the 7.65 percent FICA tax on that salary! Furthermore, children under the age of 21 who are working for their parents' business are exempt from federal unemployment taxes.

Myth: A reasonable salary is only minimum wage.

• **Fact:** The IRS considers a reasonable salary to be the amount required to pay an outsider, with similar experience in your practice's location, to do the same task. For example, if you are hiring your child to collate and stamp mass mailings in Atlanta, Ga., it is considered reasonable to pay someone approximately \$8 to \$10 an hour for that type of work. Likewise, paying a fee of \$40 every time your child mows the office's lawn would be reasonable. If you wish to hire your child to do Web site administration, then a reasonable rate for that job would be much higher — in the range of \$30 to \$40 an hour.

Myth: I need to start paying my child on a weekly basis, and let him or her keep the cash.

• **Fact:** You can pay your child as infrequently as you wish. Probably 75 percent of dentists who are already paying their children write them a monthly check. Others pay their children once a quarter, or immediately after they have completed a job. The child is not required to keep all of the cash in a simple checking account. I recommend putting some of the money into an IRA, some in a

money market account to earn interest, and some into a regular checking account that your child can access when needed. Money in checking or money market accounts, which was saved in either a no-tax or low-tax way, may then be used to pay for private school. For example, in 2005, your son or daughter could make a nondeductible contribution of the lesser of \$4,000 or his or her taxable compensation into a Roth IRA so that qualified distributions — at a later date — will be tax-free when withdrawn. Here's another tax tip. Qualified distributions may be made up to \$10,000, and then can be distributed later for your child's first home purchase.

Children — Tax returns and limits

Myth: I have heard about a "Kiddie Tax." That means all of my children's income will be taxed at my high tax rate.

• **Fact:** The Kiddie Tax is a tax on a child's unearned income (such as rental and investment income) that, for 2005, is in excess of \$1,600. This tax only applies to children ages 13 and under. Earned income is taxed at the child's tax rate, not yours (regardless of age). So, it's time to do "The Slide." If you are a practice owner, or an associate with your own LLC or corporation, slide some salary and assets to your children and create some low-taxed income. For example, if you are in the 40 percent tax bracket for 2005 (which includes 5 percent for state taxes), and you pay your daughter \$5,000 during the year, (and she has no other earnings), you will save \$2,000 (40 percent of \$5,000) in federal income tax with no cost to your daughter. She will be able to use her standard deduction of \$5,000 to reduce her taxes to zero. As a family unit, you can save thousands of dollars in taxes and use the savings, your "found money," to pay for private school. Or use the found money to invest and save for future college expenses. But the savings don't stop here! At your child's low tax rate of 10 percent — for taxable income up to \$7,300 for 2005, or total earned income of \$12,300 because of the standard deduction — you pay a low tax on income that must be reported on your tax return at your high tax rate. If you have three children and save \$2,000 for each child, then you have really saved \$6,000 per year. What's more, your children have funded a Roth IRA that will grow exponentially!

Children — Gifting assets and taxes

Myth: Some of my friends shifted assets to their children, and then had to pay gift taxes. I need to pay gift taxes on everything I give the children.

• **Fact:** Some advanced tax strategies can help you achieve your financial goals without depleting your annual gift tax exclusion of \$11,000 per person. For instance, if you are planning to buy a dental office building, land, or in-house lab, consider forming a Family Limited Partnership (FLP) or a Limited Liability Company (LLC) at the

PAYING FOR PRIVATE SCHOOL

outset. This way your children can report income on their tax returns, not yours. Another idea is to gift depreciated dental equipment to your children so they can recognize lease income as well as the gain on its future sale. The goal is to do “The Slide,” and slide income-producing assets to your children or grandchildren.

Myth: I now have grandchildren for whom I'd like to pay some private school expenses. This will cost me gift taxes.

☛ **Fact:** Grandparent gifting is an important component of many families' funding plans for education. As a grandparent who wishes to pay for private secondary education, you can avoid all gift taxes simply by mailing your check directly to a school instead of your grandchild. If you would like to assist grandchildren with college expenses, you can establish 529 Plans in the names of your grandchildren. As a practicing dentist, you also can pay grandchildren for any tasks they complete for you and your practice.

Children — Education savings accounts and 127 plans

Myth: I have money saved in a 529 Plan. I can use this money to pay for private secondary school.

☛ **Fact:** 529 Plan money may be used to pay for college expenses; however, (without incurring a penalty) the money cannot be used to pay for secondary education costs. Please refer to Part 2 of this series next month to learn more about 529 Plans, and how this money may not be tax-free when used.

Myth: I have heard about Coverdell education savings accounts. I can use one of these accounts to pay for private school.

☛ **Fact:** It is true that Coverdell accounts may be used to pay for private secondary school; however, you will probably not qualify for this savings method. The amount of money you can deposit into a Coverdell account is reduced if your income exceeds \$190,000 for a married couple (\$95,000 for a single person), and is totally phased out at an income of \$220,000 for a married couple (\$110,000 for a single person). If you have a joint income greater than \$190,000 or \$95,000 (single person), then your contribution is greatly decreased from the maximum contribution of \$2,000 per beneficiary. Here's a tax tip. If your child files a tax return (or if you have income below these phaseout limits), then you should consider funding a Coverdell account. Keep in mind that you cannot fund both a Coverdell and an IRA in the same year.

Myth: Section 127 plans and employer educational assistance plans can only be established by large corporations.

☛ **Fact:** All dentists should consider offering a Section 127 plan when appropriate; however, there is a narrow

set of circumstances in which this plan is effective for the children of highly compensated officers. Often you can use this plan to help pay for the last two years of undergraduate college education as well as graduate study. The 127 Plan will be discussed more in Part 2 of this series. This type of plan is ideal to start when your child is age 21 or older. If your child fits the criteria, your business can deduct up to \$5,250 per year of tuition benefits. Here's another tax tip. Practice owners who are grandparents may be able to offer this plan in a cost-effective manner to grandchildren who are starting college. They can use the deduction for four years of undergraduate school as well as for graduate school.

Please keep in mind that these tax strategies are merely suggestions. All tax strategies should be reviewed with your tax advisor so you can coordinate tax savings in your specific financial situation. For assistance on education and college funding techniques and strategies, consult with a Certified College Planning Specialist (CCPS). One may be found at www.niccp.com. By taking these steps, you can determine your financial health and goals, and then begin taking steps to achieve these goals.

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