Did You Know Employing Your Kids Means More College Savings Options? How Your Children can Use an IRA

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You probably already know about, or have at least heard of, 529 plans as an investment option for paying for your child's college education. But, did you know that if you employ your kids in your business, you actually have an option that other people don't? Children who are employed by their parent's company have the ability to use an IRA account to pay for college *without* penalties. That's a huge advantage!

How It Works

Depending upon how much your children make working for your business, they may benefit more from either the Roth IRA or the traditional IRA—either one is available for their college savings.

Here are the primary reasons that it's a good choice:

- **For qualified higher education expenses, such as tuition, books, fees, room and board, and even supplies, a child can withdraw the money penalty-free.**[1] As long as the child only withdraws the amount needed for qualified expenses, the ten percent early-withdrawal tax does not apply.[2] Of course, for the traditional IRA, regular federal income taxes will apply. Keep in mind that for some costs, the student must be enrolled at least half time in order to qualify.
- **It's possible that the IRA won't be factored in when determining student and parent resources for financial aid decisions.** The Free Application for Federal Student Aid (FAFSA) is the financial aid form used by most public higher education institutions. This form *does not* include a section asking about IRAs because it is not typically an asset that is considered available as an educational resource.[3] However, private institutions are more likely to consider the IRA an educational asset and factor that in.[4] If your student is able to exclude the IRA from FAFSA calculations the first year of college, be aware that any IRA distributions **will** be counted as income on the FAFSA the next year. That is, money in the child's IRA is not calculated, but money taken out of the IRA is.[5]
- **The money grows tax deferred.** Because this provides your child with a great head-start on compounding interest, you should start your child's savings early and continue it until age 18. Child labor laws do not apply to children who work for their parent's business (unless the business is particularly dangerous—check the guidelines if you're unsure), so your child can start earning as early as they can provide a

valuable service to your business. This could be as early as seven years old. Of course, this only works if the chosen investments provide a good return.

- Here’s an example of 12-year growth for a child who contributes $5,000 annually. A 0 percent annual return gives them $60,000. A 2 percent return equals $68,402. But, a 15 percent return garners a total of $166,760 after 12 years.

- **The account could help to reduce or eliminate the kiddie tax imposed on children’s investment income.** The kiddie tax imposes the parents’ tax rates on the child’s income. Let’s say your child earns $6,200 at your business for the year (that is the standard deduction for 2014), and they also received $5,000 in investment dividends ($11,200 total). They would have to pay taxes at your tax rate for the additional $5,000. But, if your child contributes their dividend income into a traditional IRA, then they are left with zero taxable income.
- **Even if the child’s income is too low to be taxable, they can use a Roth IRA to continue growing the money and deferring taxes.** Usually taxes are paid up-front for the Roth, but in this case, there are no taxes to pay up-front! That means when your child withdraws money from their basis, they do not have to pay taxes when the money goes in nor when it’s withdrawn. If the child contributes $6,000 every year for 12 years, they’ll have $72,000, none of which they ever have to pay any taxes for (because the yearly contribution is less than the standard deduction)! Of course, any interest earned on that amount *will* be subject to taxation upon withdrawal. A traditional IRA, by contrast, does not have a tax-free basis because the contributions are tax-deductible.
- **If the child earns more than the standard deduction, they get double benefits.** Your child will want to get the tax deduction from contributing to a traditional IRA if they earn more than the standard deduction in combined work income and investment income. This means they get the tax deduction, and the money then grows tax-deferred.

It really does pay to employ your children, and the advantage is certainly not all on your side. You can give them a helpful step towards a financially secure future, including making college more affordable and teaching them valuable lessons about how to grow their money. When choosing an IRA for your child, the Roth IRA is best for those earning less than the standard deduction. Otherwise, you’ll want to defer a larger sum of the taxes by choosing a traditional IRA and reducing (or eliminating) their tax bill.

1. IRC Sections 72(t)(2)(E); 72(t)(7)(A); 529(e)(3). ^
2. Notice 97-60, Section 4. ^
3. “ASK THE BIZ BRAIN,” Business p. 007, The Star-Ledger (Newark, New Jersey), August 10, 2009 ^
4. “ASK THE BIZ BRAIN,” Business p. 005, The Star-Ledger (Newark, New Jersey),

October 11, 2009. ^
5. “Roth Can Be Expensive Gift for 16-Year-Old” by Gail MarksJarvis, (Business; Zone C; p. 5), Chicago Tribune, July 8, 2007. ^