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Saving for college: Study your options and plan ahead

Costs for college tuition and related expenses continue to soar. In fact, during the past decade, tuition and fees rose an annual average of 2.9% after inflation for private four-year colleges, and 4.4% for public four-year institutions, according to a 2007 College Board report.

Such reports should light a fire under parents who are dragging their feet when it comes to saving for college. Let's look at some options that may help you reach your goals — financially and academically.

Education savings plans

Popular tax-advantaged education savings vehicles include Coverdell Education Savings Accounts (ESAs) and Section 529 plans:

ESAs. An ESA is a type of investment trust account to which you can make nondeductible contributions of up to $2,000 annually. Contributions grow tax free, and account distributions for qualified education expenses are generally also tax free. The tax treatment may vary if you claim multiple tax breaks for the same expense. For instance, you can't use the same expenses for calculating tax-free withdrawals from an ESA and for claiming the Hope or Lifetime Learning credit. (See page 3.)

For you to qualify to make the full $2,000 contribution, the combined adjusted gross incomes (AGIs) of you and your spouse must be less than $190,000 ($95,000 if you're a single filer).

If your combined AGIs are equal to or greater than this amount, your ability to contribute to an ESA will be reduced or even be eliminated altogether. If your AGI is too high to qualify and your child's AGI is below the applicable limit, have him or her make the contribution. The child's contribution may include money gifted to him or her.

ESAs can also fund expenses for elementary (including kindergarten) and secondary school.

There are some caveats: You generally can't contribute to the ESA once the beneficiary reaches age 18. And, if more than one ESA is established for a given beneficiary and the aggregate contributions exceed $2,000, you'll face a penalty. In addition, the child generally must withdraw the account holdings before he or she reaches age 30 to avoid taxes and penalties.

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Section 529 plans. These plans may be set up as a prepaid tuition program to secure current tuition rates, a tax-advantaged savings plan to fund college expenses or a combination thereof. Generally, 529 plan investment earnings grow tax free. And distributions used for qualified education expenses are generally free of federal income tax. Account savings usually can be used to pay expenses at any accredited college or university in the United States and some foreign institutions.

Although 529 plans provide fewer investment options than ESAs, anyone can contribute much larger amounts to the plan than they can with an ESA, and there generally are no beneficiary age limits for contributions or distributions. Special gift tax rules even allow you to use five years of annual exclusions (currently $12,000 per year) all at once. You retain control over the account and generally

may reclaim funds for yourself at any time. Earnings on nonqualified withdrawals will be subject to income taxes and penalties, however.

IRAs and savings bonds

You can withdraw funds from a traditional IRA or Roth IRA for education expenses without incurring early withdrawal penalties. But you'll sacrifice the opportunity for the funds to continue to grow tax-deferred (or tax free, in the case of the Roth IRA) for your retirement. Also, you'll be taxed on the distribution, though for Roth IRAs only the portion attributable to earnings will be taxed.

Under the U.S. Treasury Department's Education Bond Program, interest earned on Series EE and I bonds may be excluded from your gross income to the extent of qualified higher education expenses, so long as the bonds were purchased after 1989 by someone at least 24 years of age. However, the tax exclusion is subject to income limits and phaseouts.

Education tax credits

There are two education-specific federal tax credits, both of which can apply to tuition and fees:

- The Hope credit of up to $1,800 annually per *eligible student,* and
- The Lifetime Learning credit of up to $2,000 per *annual return.*

Note that these credits are subject to AGI-based phaseouts. But if your income is too high, your child may be able to claim the credit instead.

A balanced savings strategy

An effective investment strategy should provide for your family's college funding needs and also align with your overall financial goals and long-range retirement plans. Consult your tax advisor for help in determining the most effective combination of education investment options. ◈

Enhance your estate planning with a joint purchase

Estate planning tools can range from simple to mind-numbingly complex. While a sophisticated strategy is often the best way to accomplish your objectives, in some cases the simplest technique can be powerfully effective.

Take the joint purchase of a home. Not to be confused with joint ownership, a joint purchase involves one group (usually a parent or parents) who buys a current interest in the home and another (typically one or more children) who simultaneously buys the remainder interest. The current interest can be for a term of years or for life. When the term ends or the current owner dies, the home passes to the owner of the remainder interest. The portion of the home's cost to be paid by each is determined based on life expectancy tables.

A joint purchase offers many benefits. The current owner gets to live in the home, but the price is discounted from its fair market value. And the future owner pays only a fraction of the property's current value, but receives the home free and clear when the current owner dies or the term ends.

The most significant benefit, however, is gift and estate tax savings. Provided each buyer pays "full and adequate consideration" for his or her interest, the home's value — including all future appreciation — escapes transfer taxes. Plus, while family members are limited to using this technique to transfer a *home,* unrelated persons can use it to transfer virtually any type of property.

The joint purchase isn't without disadvantages and complications, however. The owner of the remainder interest must come up with the funds needed to make its portion of the purchase. Also, unlike with inherited property, which enjoys a stepped-up tax basis, the remainder interest's basis is equal to its purchase price — so the future owner may incur a substantial capital gain — and it won't qualify for the exclusion on sale of a principal residence.

But, under the right circumstances, a joint purchase offers a simple, yet powerful, tool for achieving significant tax savings.

Is your company protected?

The independent contractor vs. employee dilemma

The IRS has been working hard defining worker classification. What's at stake for your company? Depending on its size, if you misclassify an employee as an independent contractor, you'll likely face substantial financial consequences. Fortunately, there are steps you can take to protect yourself.

What are the rules?

In the traditional employer-employee relationship, the employer is responsible for withholding federal and state income taxes, paying unemployment taxes (FUTA), paying its share of FICA and Medicare taxes, and withholding the employee's share.

Even if workers you treat as independent contractors pay their taxes, the IRS still may hit you with penalties.

Independent contractors are responsible for their own taxes. In addition to making estimated tax payments for their federal and state income tax liabilities, they're subject to self-employment tax, which covers both the employer and employee shares of FICA. They're entitled to a deduction, however, for the "employer's" half.

Why does it matter?

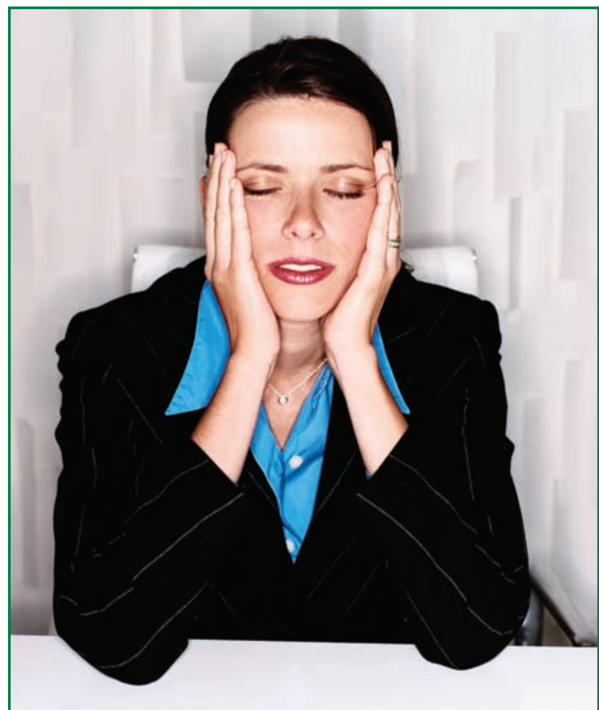
Some think that the IRS doesn't care how a worker is classified so long as the agency receives all the taxes it's owed. But, in fact, the IRS has a strong preference for *employee* status. That's because it's easier and cheaper to collect taxes from a single employer than from multiple independent contractors.

Even if workers you treat as independent contractors pay their taxes, the IRS still may hit you with penalties equal to 20% of your tax liability if it finds they should have been classified as employees. And if they don't pay their taxes, the IRS can go after your company for back taxes, penalties and interest. If the IRS reclassifies independent contractors as employees, your company will be liable for all payroll and income taxes that should have been withheld.

Additional penalties may apply if the IRS finds that you intentionally disregarded your tax obligations. And, of course, your state may impose penalties of its own. Finally, "responsible persons" — including certain officers, partners and managers — could be personally liable for uncollected taxes.

How can you protect yourself?

The simplest way to avoid these consequences is to treat workers as employees unless they obviously qualify as independent contractors. Historically, the IRS examined 20 factors to determine whether a worker is an employee or independent contractor. Recently, however, the agency consolidated those factors into 11 considerations that indicate the degree of control exercised by the employer and the degree of independence. (See "A question of control: How the IRS classifies workers" at right.) Make sure you evaluate your relationship with each worker in light of the IRS test,



resolving any doubts in favor of employee status.

If you determine that a worker is an independent contractor, you can gain additional protection by complying with the "Section 530 safe harbor." This isn't a safe harbor in the usual sense of the term, because it doesn't prevent the IRS from reclassifying workers *going forward.* But it does relieve you of liability for back taxes, interest and penalties if you have a reasonable basis for your classification.

To qualify for the safe harbor, you must first show that 1) you didn't treat the worker, or any other workers in substantially similar positions, as employees during any prior period, and 2) you consistently filed all required tax returns for all prior periods.

Next, you must show that you had a reasonable basis for treating the worker as an independent contractor, such as:

- Court opinions, IRS rulings or other precedents,
- A prior employment tax audit,
- A longstanding, recognized practice of a significant segment of the worker's industry, or
- Advice from a qualified accountant or attorney.

Qualifying for the safe harbor may not be a simple task. There may be conflicting court rulings, for example, or differences of opinion on whether an industry practice is "recognized" or a position is "substantially similar."

Whom can you turn to?

Given the financial consequences of misclassifying workers, this is one area where you shouldn't go it alone. Get advice from your tax advisor to help ensure you classify workers correctly and insulate yourself from liability in case a classification is challenged. ◈

A question of control: How the IRS classifies workers

To determine whether a worker is an employee or independent contractor, the IRS considers the degree of behavioral and financial control the employer exerts over the worker, as well as the parties' relationship.

Behavioral control

For this, the IRS looks at:

Instructions. Employees usually receive detailed instructions about when, where and how to work.

Training. Employees may receive training on how to perform their services; independent contractors typically use their own methods.

Financial control

Facts that indicate the level of control include:

Business expenses. Independent contractors are more likely to incur unreimbursed business expenses.

Investment. Independent contractors often make significant investments in facilities, equipment, and so forth.

Marketing. Usually, independent contractors are free to seek other business opportunities in the relevant market.

Method of payment. Employees are usually paid by the hour, week or some other period; independent contractors generally (but not always) receive a flat fee or submit an invoice for services.

Profits. Independent contractors can make a profit or suffer a loss.

Type of relationship

Factors that indicate the parties' relationship include:

Written contracts. A contract will describe the worker's intended status.

Benefits. If the business provides the worker with insurance, a retirement plan or other employee benefits, that may indicate an employee/employer relationship.

Permanency of relationship. Employees are more likely to be hired for an indefinite period.

Importance of services. Workers who provide services that constitute a key aspect of normal business activities are more likely to be considered employees.

No one factor controls the outcome. You need to examine and weigh all the factors to determine whether a particular worker is an employee or independent contractor.

Don’t let multistate taxation multiply your taxes

Technological advances have made it much easier to do business across the country and around the world. But these new opportunities come at a price: If you do business across state lines, it’s important to analyze your activities in each state to avoid triggering unwanted taxes.

Making the connection

Another state can apply its income, franchise or sales and use taxes to your business if you’ve established a sufficient connection, or “nexus,” with that state. Historically, nexus required a physical presence in the state, such as offices, manufacturing facilities or employees. Physical presence is still required today to trigger sales and use tax collection obligations, but many states require only a minimal presence to establish nexus, and the courts have agreed.

Federal law prohibits a state from taxing a company’s income if its only activity in the state consists of soliciting orders or sales of tangible personal property, which are approved and shipped from outside the state. But the law doesn’t apply to *intangible* property. Thus, several recent cases have allowed states to tax an out-of-state firm’s income on intangibles, such as trademark licenses or credit cards, even though the firm had no *physical* presence in the state. A substantial *economic* presence was sufficient.

Franchise tax, which is a tax on the privilege of doing business in a state, often requires even less of a connection. Simply soliciting orders or sales in the state may be enough.

Assessing your exposure

Whether your company is exposed to multistate taxation depends on many factors, including the nature of your business, the tax laws in the states in which you do business, and your activities in those states.

It’s important, therefore, to determine your tax obligations, if any, in each state and be sure you’re in compliance.

Finding tax-saving opportunities

Multistate taxation isn’t necessarily a bad thing. For example, to avoid multiple taxation of the same income, most states require that you apportion income among various states, typically using a formula based on a company’s sales, property and payroll in each state, though various states weight each factor differently or use only one or two of the factors.

Suppose that your company is located in a state with a very high corporate income tax, but you do a significant amount of business in states with low or no income taxes. Because you lack nexus with those states, all your income will be taxed by your home state. But if you create nexus with one or more of those states (by setting up a small office, for example, in a state where your sales are significant) you may be able to allocate some income to those states, lowering your overall tax bill.

Making a plan

The impact of multistate taxation on your business depends on your particular circumstances. But whatever that impact may be, it’s critical to assess your situation and develop a plan for addressing your tax obligations and making the most of planning opportunities. ◈

Reduce your environmental footprint and kick up your bottom line

With growing concerns over pollution, global warming and wasteful consumption of nonrenewable resources, businesses are under pressure to reduce their environmental "footprint."

It begins in the office…

Start with basic office environmental savers, such as stocking break rooms with durable mugs, plates and utensils. Repair or replace leaky plumbing, outdated light fixtures and any energy-guzzling appliances. Make it a companywide practice to recycle glass, metals, plastics and paper and properly dispose of hazardous waste.

You can make a difference by purchasing recycled or eco-friendly goods. Recycle or donate vs. tossing surplus office equipment and supplies. Instead of buying new, refill and reuse printer toner cartridges. Also, try to go paperless in your office by creating electronic portable document format, or PDF, files and e-mailing them as needed. And reuse "gently used" paper stock for scratch pads.

…and travels with you

Switch company cars to the more fuel-efficient or hybrid models. Encourage your employees to use public transportation if available. You also can reduce your company's carbon footprint by cutting down on long-distance travel.

It affects facilities maintenance…

Upgrade your facilities with energy-efficient roofing, insulation, windows and lighting. Install programmable thermostats to help reduce energy loss and cut utility costs. And remember to regularly change filters and clean machines to optimize performance.

Employ green cleaning practices by replacing harsh, toxic cleaning solvents with safer solutions. This will not only help minimize hazardous environmental waste, but may also prevent "sick building syndrome" and associated employee health issues and costs.

Also important: Select energy-efficient, durable cleaning equipment and ensure that maintenance staff are properly trained in how to safely apply cleaners. This includes how to reduce the release of excess cleaning solution particulates into the air.

Transportation FSAs

You can help out your employees by offering a flexible spending account to cover a portion of their transportation costs. Workers can redirect part of their salary pretax to an account for transit and parking expenses and then be reimbursed — tax free — from the account. Monthly expense limits for 2008 are $220 per month for parking and $115 per month for transit passes and commuter highway vehicles.

…plus production and distribution

Your customers and clients will likely take note of any earth-friendly tactics you introduce in your production and distribution processes. For example, use product materials and packaging that are toxin free and reusable, and that generate less waste. Leverage industry or state material-exchange programs for reusable production scrap and waste materials.

Finally, cut transportation energy use and costs by streamlining product distribution routes. Source locally and save on waste with reusable or recyclable shipping containers where possible.

Take the first step

The rewards for going green can be great: You'll not only feel better because you're helping preserve the planet, but you'll be raising your image in your community. Finally, ask your tax advisor if your business qualifies for any federal or state tax breaks on environmental improvements made. You may just get some green back. ◈

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