TAX GUIDE
for parents

Being a parent brings tremendous rewards, but also challenges and responsibilities. Among these are the financial burdens of supporting and educating your child. Fortunately, the tax code has many ways to help ease those burdens. Here's an overview of the many ways that taxes can affect your decisions as a parent.

■ Being a parent usually cuts your tax bill in at least two ways. You can generally claim a dependency exemption for each child under age 19, or under age 24 for full-time students. You can also claim a child tax credit for each child under age 17. This is a direct credit against taxes you owe, and it can be partially refundable.

■ Other credits include the adoption credit to offset expenses of adoption and the child care credit to offset some of the costs of paying for child care for working parents.

■ The dependency exemption and all of the credits mentioned here phase out for those at higher income levels.

EDUCATION expenses

■ One of the biggest challenges for a parent is funding a child's college education. A variety of tax breaks can help with this major expense, including savings plans, tax credits, and tax deductions. These measures all have different rules and eligibility requirements.

■ There are two main types of savings plans for education expenses: Coverdell education savings accounts and Section 529 plans. Coverdell accounts work somewhat like an IRA. Contributions are not tax-deductible, but they grow tax-free, and withdrawals are free of tax if used for qualified education expenses. Section 529 plans provide tax-free earnings and distributions for higher education expenses, and they generally have fewer restrictions than Coverdell accounts. However, Coverdell accounts can also be used to pay for K-12 expenses as well as college costs.

■ The American opportunity credit and the lifetime learning credit are two tax credits available for education expenses. Each has its own rules and income limits, and you cannot use both credits for the same child in the same year.

■ A limited tax deduction is available for student loan interest expense. In addition, interest on U.S. savings bonds can be tax-free if the bonds are used for education expenses.

CHILD tax issues

■ The "kiddie tax" is a rule that affects the investment income of children. A child's unearned income above a threshold amount will be taxed at the parent's highest rate until the child reaches a certain age. The intent is to stop a high-income parent from shifting large amounts of earnings to a child in a lower tax bracket.

■ A strategy of "income shifting" can make sense for a child once he or she is old enough to escape the kiddie tax. Parents can gift income-earning assets to older children (subject to the annual and lifetime gift limits), and the children will pay tax on the income earned at their own rates.

■ Another tax-cutting strategy is to employ your child in the family business. The business can take a deduction for wages paid, while the child often pays little or no taxes on his or her earnings. It must be a real job, though, and the wages must be reasonable for the work.

■ If your children have earnings from summer or after-school jobs, encourage them to open IRA accounts. The additional years of tax-free compounding can produce huge additional savings by the time your children reach retirement age.

■ Don't overlook the role of grandparents. They can help pay college expenses, for example, either by contributing to education savings plans or by paying tuition bills directly. Also, by giving appreciated stock to their grandchildren, they may be able to boost the children's savings while reducing overall taxes for the family unit.

ESTATE planning

■ For a parent, estate planning is especially important. The first priority is to make sure your children are protected in the event that something happens to you. Your estate plan should appoint guardians for your minor children, as well as provide for their financial well-being.

■ Early estate planning can also help to ensure that your assets pass to your children as you consider prudent. A variety of planning techniques can allow you to transfer assets to your children over the years, often while still leaving you with some control over the assets.

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