

## The New Effects of the “Kiddie Tax” On Income Shifting

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*“It’s very important that you try very, very hard to remember where you electronically transferred Mommy and Daddy’s assets.”*

ability to shift income to your children, you should understand how the government treats unearned income in the hands of your kids.

Under the expanded Kiddie Tax rules, your minor children may continue to receive a tax break – to a certain extent. For the tax year 2007 the first \$850 unearned income is exempt from taxation. The next \$850 of unearned income is taxed at your child’s marginal tax rate. Any amount of unearned income above \$1,700 that you shift to your child however, gets taxed at *your* marginal tax rate. That makes your child responsible for that tax liability not you.

Its important to not that the Kiddie Tax applies only to unearned income such as dividends, interest, and capital gains – not income your child earns through employment. And it does not apply to investment income for married minors under 18 who file jointly.

If you had been thinking of transferring ownership of assets that produce over \$1,700 of annual unearned income to your children, you might need to reconsider the benefit of doing so.

The slight tax advantage that remains under the current law can be gained only by gifting assets that are likely to produce no more than \$1,700 annually. In receiving this reduced tax benefit, however, you also lose control of the assets. Gifts to children in the form of securities or other financial instruments are generally made through the use of custodial accounts, such as Uniform Gifts to Minors Act (UGMA) or Uniform Transfer to Minors Act (UTMA) accounts. Once the custodial accounts are funded by your shifted assets, your gift is irrevocable and may only be used for the benefit of the child who is named as the account’s beneficial owner.

Is the loss of flexibility worth the relatives low tax savings? That’s your decision. Rather than gifting assets to children through the use of custodial accounts and complex trusts, you could keep the assets in your name to maintain flexibility. Since the tax benefits have been significantly reduced, maintaining control of the assets may be you most prudent choice. Also, consider using a 529 plan to fund your child’s future educations in a tax-efficient manner. Neither you nor your child is taxed on unearned income generated from contributions to a 529 plan. Distributions from 529 plans are not included in income if those distributions are used to pay for qualified higher education expenses.

The recent expansion of the Kiddie Tax to children ages 18 or younger has closed a well-known tax loophole that many parents utilized. To make matters worse, the change was retroactive to January 1, 2006-so be prepared to face a higher tax liability than originally planned if you made a gift last year to take advantage of shifting income to you children. Please contact a certified financial planner or certified public account for planning strategies of this recent change.

Submitted by Kerri Sullivan-Kreiss, CFP®

With Congress’ recent tightening of the so-called “Kiddie Tax” loophole, some parents have lost a way to lower their income tax burden. In the past, parents often shifted income generated from their investments to their children. The income was hen taxed at the child’s marginal tax rate, which is generally lower than that of the parents. But Congress realized the millions of potential dollars being lost and recently expanded the scope of the Kiddie Tax to include all children under the age of 18, rather than the previous age of 14.

The Kiddie Tax is applied to unearned income that a child under 18 receives in a given year above a certain limit. For 2007 that figure is \$1700.

While the increase to age 18 certainly hinders you

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