ALLIANT ADVISORS

FIND DIRECTION

The Navigator

Important Markers To Guide Your Way

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Welcome! At Alliant Advisors we have the passion to help our clients Find Direction for both business and personal goals. To support this promise we will continue to send you bits of helpful and useful information through e-mail to keep you up to date on any current changes, due date reminders or other information that may be relevant to your specific needs.

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The Alliant Team

KIDDIE TAX CHANGES ON THE WAY

As you probably know, after a bitter battle with Congress, an Iraq funding bill was recently signed into law. This legislation also included various changes to the tax laws including significant changes that can affect families with children under age 24. These changes involve the so-called kiddie tax and as a practical matter will first apply on 2008 tax returns. While the changes do not go into effect until next year, now is the time to undertake planning to reduce or eliminate the potentially higher family income taxes that could result from them.

The kiddie tax curtails the ability of parents to significantly lower their family's tax bill by transferring investment assets to low-taxed minor children. For 2007, a child under age 18 pays tax at his or her parent's highest marginal rate on the child's unearned (investment) income in excess of $1,700. However, the kiddie tax does not apply to a child who is married and files a joint return for the tax year. Unearned income within reach of the kiddie tax includes interest, dividends and capital gains.
The new law did not change the kiddie tax rules for children under age 18. But it did expand the kiddie tax to apply (starting next year) where:

> ... a child turns age 18, or turns age 19-23 if a full-time student, before the close of the tax year;
> ... the child's earned income for the tax year doesn't exceed one-half of his or her support;
> ... the child has more than $1,700 of unearned income (but the $1,700 may be higher after an inflation adjustment is released later this year for 2008);
> ... the child has at least one living parent at the close of the tax year; and
> ... the child doesn't file a joint return for the tax year.

This expansion of the kiddie tax rules attempts to curtail a strategy some wealthy (and some moderate-income) parents were advised to use to take advantage of a beneficial feature of the long-term capital gains rate. This year, the top tax rate on most long-term capital gains and corporate dividends is 15%. But to the extent these items would otherwise be taxed in the two lowest tax brackets—i.e., the 10% and 15% brackets—they are taxed at 5% for 2007, and 0% for 2008 through 2010. Some families sought to benefit from these rates by gifting appreciated stock, mutual-fund shares, and other securities to their low-income, young-adult children who (if no longer subject to the kiddie tax rules and if in one of the two lowest tax brackets) could then sell them tax-free in 2008, 2009, and/or 2010. The new law changes will eliminate the opportunity to do this in many cases and can have a negative impact on families that did not engage in transfers of capital assets to children. However, if the earned income of a child over age 18, or age 19-23 if a full-time student, exceeds one-half his or her support, the kiddie tax rules won't apply and he or she will be able to take advantage of the 0% capital gains rates and his or her own bracket on other types of unearned income.

A child who was planning to sell stock next year to take advantage of the 0% capital gains rate but who would be snared by the expanded kiddie tax may be able to sell this year to gain the advantage of the 5% rate. This won't work if the child is subject to the kiddie tax this year.

On the subject of earned income (e.g., from wages or self-employment), it is always taxed at the child's tax rates. Thus, one way of providing a child with income without triggering increased tax liability under the kiddie tax rules is to employ the child (at reasonable compensation) in a trade or business owned by the parent. As an added bonus, this could help to avoid the kiddie tax on unearned income of a child age 18 or age 19-23 if a full-time student.

Because of these impending changes, a parent may want to reconsider any planned transfers of income-generating stocks, bonds, and other investments to children age 18, or those age 19-23 who are full-time students. However, placing or moving a child's funds into investments that produce little or no current taxable income, can help avoid the kiddie tax. These investments include, for example, stocks and mutual funds oriented toward capital growth that produce little or no current income; vacant land expected to appreciate in value; stock in a closely-held family business that pays little or no cash dividends; tax-exempt municipal bonds and bond funds; and U.S. series EE savings bonds for which interest reporting may be deferred.

Investments that produce no taxable income, and that are therefore not subject to the kiddie tax, also include tax-advantaged savings vehicles, such as, traditional and Roth IRAs (which can be established or contributed to if the child has earned income); qualified tuition programs ("529 plans"); and Coverdell education savings accounts ("CESAs").

Please contact us at 847-490-1040 if you would like to learn more about the expanded kiddie tax or any of the strategies for avoiding it.