

GARDNER WILLIS

SWEAT & HANDELMAN, LLP

June 29, 2007

ATTORNEYS AT LAW

P. O. Drawer 71788
2408 Westgate Drive
Albany, Georgia 31708-1788
Website: www.gwsh-law.com

SUGGESTIONS FOR PRESERVING WEALTH

SMALL BUSINESS TAX ACT PROVIDES FOR EXPANSION OF THE “KIDDIE TAX”

The recently-enacted Small Business and Work Opportunity Tax Act of 2007, signed by the President on May 25, 2007, makes some important changes in the “kiddie tax” that is imposed on the investment income of minor children. Not surprisingly, Congress has expanded the tax, and starting in 2008, it will be imposed on children as old as age 23.

Before describing the new provisions of the “kiddie tax,” it is instructive to review the rationale for the tax. As originally enacted in 1986, it was imposed on the investment income of children under age 14, to the extent that the child’s investment income exceeded a base amount (currently \$1,700). At the time, Congress believed that well-to-do parents were shifting income-producing assets to their children, where the income would be subject to a lower tax rate. The “kiddie tax” forced these under-age-14 children to calculate the tax on their investment

income twice – once at their own tax rates, and again at the marginal rate of their parents. Whichever tax was higher was the one they paid.

The “kiddie tax” remained unchanged until 2006, when it was expanded in legislation known as “TIPRA.” Congress, searching for new revenue sources, extended the tax to all children under the age of 18. That change was effective in 2006 and caused many parents to reconsider their gift-giving plans.

Most recently, Congress again expanded the tax in the Small Business and Work Opportunity Tax Act, this time effective for 2008 tax returns. In addition to increasing the age limitation for the tax, Congress added a new level of complexity by creating three separate classes of taxpayers, each subject to different requirements for the imposition of the “kiddie tax.”



Telephone: 229-883-2441
Facsimile: 229-888-8148
Email: gwsh@gwsh-law.com

The first class of taxpayer consists of everyone who was subject to the tax before the most recent changes. This group consists of children under age 18 at the end of the calendar year who: (1) have investment income in excess of \$1,700, and (2) do not file a joint return, i.e., are not married. The second group, added by the 2007 legislation, consists of children who are age 18 on December 31, and who: (1) have investment income in excess of \$1,700; (2) do not file a joint return; and (3) have no have earned income (self-employment income or wages) that exceeds 50% of their own support.

Finally, the third group, also added by the 2007 legislation, consists of children who are age 19 through 23 on December 31 who: (1) have investment income in excess of \$1,700; (2) do not file a joint return; (3) have no earned income that exceeds 50% of their own support; and (4) are full-time students for at least five months of the calendar year.

There are several recommendations that we can make to mitigate the effect of this tax increase, especially since it will not take effect until 2008. First, once a child's investment income exceeds \$1,700, it is best to avoid making gifts of income-producing property (at least for tax-saving purposes) until the earlier of the year the

child reaches age 24 or has completed his or her education. Second, a gift of appreciated property can escape the "kiddie tax" if its sale is deferred until after the child has reached the appropriate age. Third, gifts of property that generate tax-free or tax-deferred income, i.e., municipal bonds, Series E Savings Bonds, insurance policies, and deferred annuities are fine because they will not generate any taxable income while the child is subject to the "kiddie tax." Fourth, gifts of investment property to grandchildren may make sense if their parents are in a lower marginal tax bracket than the grandparents; it is the parents' tax rate that applies, not the donors'. Finally, consider a gift to a 529 college savings plan. It is a completed gift for estate planning purposes and, because the income is tax-free to the beneficiary, it escapes the "kiddie tax."

It is clear that Congress has become increasingly hostile to the concept of shifting investment income to children. There are, however, still opportunities for reducing your gift and income tax through aggressive transfers to children, as long as you are fully aware of the new rules. If you have any questions about these rules, or are planning to make gifts to your children, we will be glad to show you how it can be done in the most tax-effective manner.

32-175.705