



**Congress sharply curtails tax strategy  
of making gifts of appreciated property  
to younger family members to  
lower capital gains tax**

The flurry of tax legislation in recent years included significant changes involving the so-called “kiddie tax” that can affect families with children under age 24. These changes went into effect for 2008 tax returns, and apply for 2008 and later years. You should be aware of these changes so that you can plan 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 children. For 2009, a child subject to the kiddie tax pays tax at his or her parent's highest marginal rate on the child's unearned (investment) income in excess of \$1,900 (\$1,800 for 2008). Unearned income within reach of the kiddie tax includes interest, dividends and capital gains.

Before 2008, a child was subject to the kiddie tax if he or she hadn't reached age 18 before the end of the tax year, unless the child was married and filed a joint return for the year. The legislation expanded the scope of the kiddie tax so that, starting in 2008, it also applies where:

- a child turns age 18, or turns age 19-23 if a full-time student, before the end 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 the prescribed amount of unearned income (i.e., \$1,900 for 2009; \$1,800 for 2008);
- the child has at least one living parent at the end 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 0% for 2008 - 2010 (5% before 2008 and after 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 law changes eliminated the opportunity to do this in many cases, and could have had a negative impact on families that didn't engage in transfers of capital assets to children. However, if the age 18 (or full-time student age 19-23) child's earned income exceeds one-half the amount of his or her support, the kiddie tax rules won't apply, and he or she can take advantage of the 0% capital gains rate, and his or her own lower tax bracket for other types of unearned income.

However, because the expanded kiddie tax rules didn't go into effect until 2008, a child who turned 18 (or if a full-time student, age 19-23) in 2007, could still sell appreciated investments in 2007 without triggering the kiddie tax. And where the child had held the appreciated securities for more than a year (or was treated as holding them that long under a rule that “tacks” on the donor's—here the parents'—holding period), the child could still be able to take advantage of the special 5% long-term capital gains rate on his or her sale in 2007.

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 recent changes, a parent may want to reconsider any planned transfers of income-generating stocks, bonds, and other investments to children who will turn 18 (or 19-23, if full-time students) in 2009. 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 if you would like to learn more about the expanded kiddie tax or any of the strategies for avoiding it.

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