[Volume 24, September 2007]

[Small Business and Work Opportunity Tax Act of 2007, Part III]

Dear Client and Friend:

This is the last of a 3-part series of letters introducing certain key tax provisions under the "Small Business and Work Opportunity Tax Act of 2007". This letter's main objective is to discuss the changes regarding the area known as **Kiddie Tax**. As a practical matter, these changes will be effective for 2008 tax returns. We should not wait until next year to find out about what will impact us, instead, we should try to understand them now.

The new **kiddie tax provisions could curtail** the abilities of parents to meaningfully lower their family's tax bite by transferring investment assets to low-taxed bracket 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 income in excess of $1,700. Unearned income for kiddie tax purpose 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 effect for taxable year beginning January 1, 2008 :

a) a child turns age 18, or turns age 19-23 if a full-time student, before the close of the tax year;

b) the child's earned income for the tax year doesn't exceed one-half of his or her support;

c) 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);

d) the child has at least one living parent at the close of the tax year; **and**

e) 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 are no longer subject to the kiddie tax rules because of age and are in one of the two lowest tax brackets, and the older children could then sell the appreciated stocks tax-free or pay tax at the 10% rate, 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 0% capital gains rates and his or her own bracket on other types of unearned income.

Regarding 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 certain planned transfers of income-generating stocks, bonds, and other investments to children age 18, or those age 19-23 who are full-time students. On other hand, 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, or previously known as education IRA.