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KIDDIE TAX REACHES WIDER AGAIN

Only a year after the kiddie tax was raised, Congress and President Bush recently enacted a broader “kiddie tax” law, resulting in higher income taxes when it comes to investments held in a child’s name to pay college costs and other major expenses.

The new provisions are not effective until January 1, 2008, giving families time to plan ahead. The “kiddie tax” imposes a parents’ marginal income tax rate on a child’s investment (passive) income that exceeds \$1,700. The kiddie tax law last year upped the age from 14 to 18. Until last year’s law was passed, the investment income on children above age 14 was taxed at their lower tax rates in the critical years heading into post secondary education. Last year’s law raised that age to 18.

The new law ups the age again, this time to 19 for financially independent children or 24 for students who do not earn enough to provide more than half of their own support.

Attorneys and financial advisors have long favored gifting strategies to lower families’ overall taxes; using those strategies, family members who are in a high tax bracket give income producing assets to those in lower brackets. Applying this idea for college-related expenses, parents and grandparents have opened custodial accounts, holding investments in the names of young children.

Generally, the investment accounts would be counted on to produce growth. The children would then technically pay their own college expenses by selling appreciated holdings, incurring little or no capital gains tax (5% rate for most taxpayers in the lower brackets). The new kiddie tax throws this planning into question, since most of the gains would be paid

at the child’s parents’ capital gains rate. The interest and dividends are paid at the parents’ higher ordinary income tax rates.

What should families do who were relying on income shifting to lessen the blow of higher education expenses? You could put your children on the payroll (if you have one to put them on) so that they can establish enough earned income to qualify under the new support test. The job must be a real job at a reasonable rate, or you might be looking at tax fraud charges.

The kiddie tax does not affect Section 529 College Savings Plans, which are named after the Internal Revenue Code section that authorizes them. Earnings on those accounts are tax free when distributed for qualified educational purposes. Section 529 plans are only a decade old; so many older children have custodial accounts.

I see this new law as encouraging 529 Plans. Wealthy families may still use income shifting techniques where necessary for estate planning motives, but if the savings are primarily intended to educate the child, you should take a hard look at 529 Plans.

You can thank the Iraq war, hurricane Katrina recovery and Congress’ appetite for spending on this tax increase, as Congress had to raise \$5 billion in revenue to pay for those items. If you have a child that was counting on paying lower taxes on investment income, cash it in before the end of 2007 and be sure to contribute as much as possible to the 529 Plan if education is the goal.

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