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What You Can Do Before the Kiddie Tax Loophole Closes

When President Bush signed new legislation in May to limit gifts to children that take advantage of their lower tax rate, it was the second time in just over 12 months that Congress extended the reach of the so-called kiddie tax, which subjects a child's income to his/her parents' higher tax rate.

Maneuvering around the kiddie tax has helped parents save for college educations for years, and given the changes, it's a good idea to consult a financial or tax adviser to discuss your options.

Congress apparently got fed up with a particular tax strategy used by wealthy families who transfer large piles of stock, mutual fund shares and other assets to their kids (who are typically in the lowest two income brackets of 10 percent and 15 percent) so they could sell those securities at a low capital gains rate. The top rate on long-term capital gains and qualified corporate dividends is 15 percent, but since 2003, those in the lowest two income brackets had a shot at a 5 percent capital gains, which is scheduled to drop to zero for those low-income taxpayers in 2008.

So here's what's happening this year and next. During 2007, investment income for a child 17 years old or younger (measured as of Dec. 31, 2007) above $1,700 is subject to his parents' higher tax rate. (Before 2006's changes in the law, the kiddie tax applied only to kids younger than 14.)

Starting in 2008, the age limit for the kiddie tax will rise to 18 and under, or 23 and under if the child is a full-time student. There are some exceptions for kids with paid jobs – the expanded provision applies only to children whose earned income does not exceed one-half of the amount of their support needs.

What you can do now

If you had put appreciated securities in your child's name and the child is a full-time student under the age of 23 but at least 18, your child can sell those securities this year and still claim the 5 percent capital gains rate. There won't be a zero capital gains rate available to your student next year, so you need to act before the end of the year to take advantage of the 5 percent rate before it becomes the parents' 15 percent rate in 2008 via the kiddie tax.

You may also want to start or redouble your efforts in the 529 college savings plans you've set up for your kids. Qualified withdrawals for education are tax-free and therefore wouldn't be subject to the kiddie tax. The same is true for qualified withdrawals from Coverdell education savings accounts.

Outside of 529 plans, you might consider investments that generate little or no taxable income such as municipal bonds.

Watch out for financial aid

Whatever gift and tax strategies you apply to your college savings strategy, make sure those assets don't undermine any efforts your child is making to secure financial aid.

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October 2007 — This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by Carreras Financial Services, Inc. a local member of FPA.