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Tax-saving transfers to children

A child under the age of 18 with investment income is generally taxed at his or her parent's top marginal rate if the income exceeds the sum of the standard deduction ($850 in 2007) and the greater of an additional amount ($850 in 2007) or the itemized deductions directly connected to the production of that investment income. However, once a child reaches age 14, all income is tax at his or her own rate. This rule sums up, in essence, what is known as the "kiddie tax."

Thus, for example, if a child has investment income of $1,700 and no other income and no itemized deductions, his or her tax bill would be $85—the tax at the child's marginal rate of 10% on the amount in excess of $850. Contrast that amount with $595, the tax paid if that same income were taxed at the parents' top marginal rate.

This suggests a strategy for making transfers to your children that is well suited to their typical financial needs. In the early years, transfers can be invested largely in growth stocks and mutual funds that don't throw off a lot of income. As the need for the money approaches, presumably for college, a shift to more stable, income-producing investments is in order, and all such income will be taxed at the child's lower rates.

Note that the kiddy tax is only imposed on *unearned* income. If you employ your children in your business, their wages are deductible business expenses, and the income is taxed at the child's rate.

Transfer taxes

Property shifted to your children naturally reduces the assets in your estate and the estate tax payable on them while the estate tax remains in effect. In order to limit the loss of revenue from this tactic, the tax code also imposes a *gift tax* at rates equal to the estate tax on large transfers made during your lifetime.

You are allowed to make up to $1 million (in 2007) in otherwise taxable gifts. This is a lifetime exclusion. The estate-tax exclusion is currently $2 million and rises to $3.5 million in 2009 before its scheduled repeal in 2010. There is, therefore, little reason (other than the need to file gift tax returns) not to make use of the gift tax exclusion. Further growth on assets transferred during life thus escapes the estate tax, and there still will be a substantial exclusion available for assets remaining in your estate at your death.

Besides the lifetime exclusion there are additional opportunities for tax-free transfers.

Chief among these is the annual exclusion. You may give gifts of up to $12,000 to as many individuals as you like without incurring a gift tax or using any of your lifetime exclusion. If you and your spouse agree to treat a gift by either of you as a "split gift," you can double the amount. (You do need to file a gift tax return in order to make this split-gift election.) That means, with four children, you can give up to $96,000 each year with no tax consequences. With adult children, their spouses and children, the total can be quite impressive.

Annual exclusion gifts must be completed within the calendar year, with no carryover of the credit from year to year. However, with the college savings or tuition prepayment accounts known as 529 plans, contributions of up to five years' worth of annual exclusion—$120,000 with a split gift—can be made at one time without incurring gift tax or depleting the lifetime exclusion. However, such a gift would "use up" the annual exclusion for gifts to that beneficiary for five years.

Also excluded from the gift tax are payments to cover someone else's education or medical expenses. When these payments are made directly to the school or medical service provider, they count against neither the annual exclusion nor the lifetime exclusion.

Capital gains and dividends

For someone in the 10% or 15% tax bracket, the tax on capital gains from assets held a year or more is just 5%, rather than the 15% that is imposed on taxpayers in the higher brackets. The same is true for certain dividend income. Thus, subject to the kiddie tax, it can make financial sense for a child to realize such gains or receive dividend income.

All in all, transferring assets to one's offspring can reduce the family's total tax burden. Be aware, however, that such transfers are irrevocable. The assets are then the children's property and may not necessarily be used as the parents might wish. The strategies, therefore, are best suited to families in which an atmosphere of mutual trust and respect prevails.

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Any developments occurring after January 15, 2007, are not reflected in this article.