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Shifting Income and Tax

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What is shifting income and tax liability?

Income shifting (also known as income splitting) may be defined as dividing income among taxpayers in a way that lowers the overall tax burden imposed on the income. Typically, income is shifted from higher bracket taxpayers to ones in lower tax brackets. Mathematically, you can describe the overall savings in tax as the present value of the difference between the tax that would be paid by the "donor" of the income over his or her lifetime, compared to the present value of the tax that will be paid by the recipient on the same income.

Although there are a number of ways to accomplish the shifting of income, the following methods are most popular:

1. Employing family members
2. Family limited partnerships
3. Interest-free and below-market loans
4. Gifting
5. Sale- or gift-leaseback
6. Trusts
7. Life insurance/annuities

When using these methods, it's always important to bear in mind the fact that the "kiddie tax" may apply to unearned income shifted to children.

What is the kiddie tax, and what is its relation to income shifting?

In the past, parents found that they could lower their taxes by shifting unearned income into their children's names. This worked because the parents were generally in a higher tax bracket than their children. Congress closed this loophole, to some extent, by enacting certain rules known as the kiddie tax.

The kiddie tax rules apply when a child has unearned income (for example, investment income). Children subject to the kiddie tax are generally taxed at their parents' tax rate on any unearned income over a certain amount. For 2014, this amount is $2,000 (the first $1,000 is tax free and the next $1,000 is taxed at the child's rate). The kiddie tax rules apply to (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support

How can employing your family members help you to shift income?

If you own your own business, one method of shifting income to other members of your family that you might employ is to hire the family members to work in your business. Paying salaries to family members reduces the amount of business earnings that you must distribute to yourself in the form of salary or dividends (or that will pass through to you, if your business is organized as a pass-through entity). In addition, you or your business (if the business is organized as a separate taxable entity) will be allowed a deduction for ordinary and necessary trade or business expenses, including a reasonable allowance for salaries or other compensation for personal services actually rendered. The IRS will look at a number of factors to determine whether compensation is reasonable. In general, a deduction for compensation paid will not be allowed unless the compensation is reasonable for the services actually rendered by the family member. C corporations can also deduct certain fringe benefits. These benefits may be excluded from the gross income of the employees.

How can income be split among family members in a family limited partnership to reduce overall taxes?

Limited partnerships can be used to split income from a business among family members. A family limited partnership (FLP) is a business entity owned by family members that is organized and operated under state limited partnership law. Typically, parents form a FLP and transfer assets (such as an existing business) to the FLP. The children or other family members then typically either purchase limited partnership interests in the FLP or receive such interests as gifts.

Although FLPs are generally thought of as a tool to minimize estate tax liability, they can also be used to shift present business income to family members in lower tax brackets. Typically, the recipients of the limited partnership interests have no right to manage the business; they are treated like investors who have an ownership interest only in the business. Each child can receive a limited partnership interest worth the $14,000 (in 2014) annual gift tax exclusion each year (or potentially double the annual gift tax exclusion if the gift is from both parents) as a gift, without gift tax consequences.

A FLP can be structured so that income generated by the business will pass through to a number of different family members. In addition, limited partners can be employed by the FLP and be compensated for services actually performed (provided that such compensation is reasonable).

How can gifts be used to shift income?

Making gifts of income-producing assets to family members is another way to shift income. For example, if you own corporate stock, you can make gifts of stock to your children in order to disburse or shift the tax impact of any dividends. (If you are making gifts of interests in your own business, and you wish to maintain control over your business, you might decide to make gifts of nonvoting stock only.)

You can make gifts of up to the annual gift tax exclusion amount each year, per recipient free from federal gift tax. Gifts in excess of the annual gift tax exclusion are subject to federal gift tax (gifts may also be subject to state gift tax). However, any federal gift tax due may be offset by your $5,340,000 (in 2014) gift tax applicable exclusion amount, if it is available.

When considering transfers of income producing assets to minor children, you should be aware that some states don't allow securities to be registered in a minor's name. In such states, if you want to transfer securities to a minor child, you may have to make the gift under the Uniform Transfers to Minors Act (UTMA) (adopted in some form in all 50 states) or the Uniform Gifts to Minors Act (UGMA) (adopted in many, but not all states) or make the gift in trust.

How can interest-free and below-market loans be used to shift income?

Another way for a family to shift income is to make a no-interest or low-interest loan to a family member as an alternative to an outright gift. For federal income tax purposes, a loan is generally considered a below-market loan if the rate of interest charged is less than the applicable federal rate set monthly by the Internal Revenue Service. In the case of below-market loans to family members, the IRS will generally impute interest (i.e., treat the lender as if he or she had received market rate interest on the loan) and treat the lender as making a gift of the imputed interest to the loan recipient. However, there are some exceptions. For example, de minimis loans (those that are $10,000 or less) generally will not result in imputed interest or reclassification as a taxable gift.

How can trusts be used to shift income?

You can transfer income-producing assets or cash into a trust for the benefit of someone else. If the trust is set up properly, income that is paid out of the trust to a beneficiary will be taxed to the beneficiary rather than to you. Thus, the trust may be used as an income-shifting tool in a manner similar to an outright gift. Many different forms of trust exist. However, if your desire is to shift income, you should be careful to avoid trust arrangements that will be treated as grantor trusts for tax purposes. If a trust is treated as a grantor trust, then the trust income is taxed to the grantor, rather than to the beneficiary.

Caution: Trust income tax brackets are quite small. Income taxed to the trust can reach the top income tax rate very quickly.

How can life insurance be used to shift income?

You can also invest some of your cash in a life insurance policy, naming a relative as the beneficiary. In this way, you can also shift income.

How can a sale- or gift-leaseback be used to shift income?

Another way to shift income is to transfer business property (such as rental real estate) by using a sale- or gift-leaseback arrangement. Typically, you would sell (or make a gift of) the property to a family member and then rent it back from the family member. As a lessee, you could deduct all rent payments made (assuming that the rental payments are reasonable, and that the property is used in your business). Potentially, the lessor would get the benefit of depreciation deductions as well as receiving rental income. In general, this type of transaction (the sale-leaseback variation) is useful to shift income from rents, to create rental deductions, to realize losses, etc. However, if the sale-leaseback variation is used, you should be aware that the sale of the property to the family member can generate taxable gain or loss, and you should also be aware that sales of property for less than an arm's-length price may be recharacterized (in part) as gifts. In addition, if the gift-leaseback variation is used (or the sale in a sale-leaseback is recharacterized as a partial gift), then there may be gift tax implications.

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