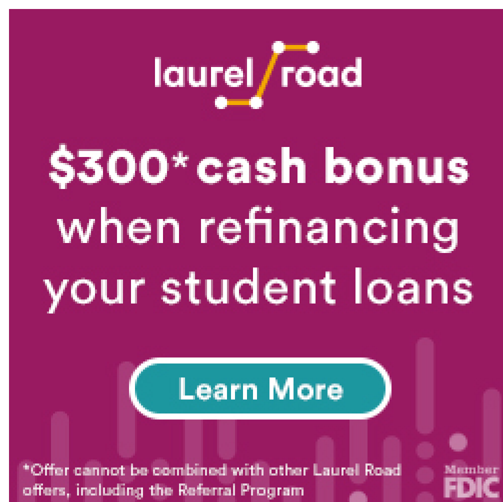
Use Your Kids To Lower Your Taxes



Kids are great. They're lots of fun to wrestle on the carpet. They say the darndest things. Every now and then they make you cry. I've been practicing my lines for when my oldest daughter shows up at my house with a guy:

> *"Son- you need to know two things about me….#1 I love my daughter very much and # 2 I'm not afraid to go back to prison."*

Kids are also useful for lowering your taxes. It's a little known secret that multi-generational tax planning can be highly effective, both for estate taxes and income taxes. Today, however, I'm only discussing the generation below yours, and I'm only discussing income taxes.

The Exemption

The first way kids are very useful is that you get an exemption for each one of them, as long as they are dependent on you. For 2014, that's $3,950 deducted from your adjusted gross income (essentially a below the line deduction that doesn't require itemizing.) Given my 33% marginal tax rate

(28% Federal, 5% state), my kids are worth $1,304 a piece, per year. Exemptions phase out too, and within the range of incomes that many physicians enjoy. In 2014, the phase-out begins at an AGI (1040 line 38) of $254,200 ($305,200 married) and ends at $372,500 ($427,550 married.) That's another great reason to maximize your retirement account contributions and other above the line deductions if you're in that range.

The Child Tax Credit

Some people even get a child tax credit in addition to the exemption. However, most attending physicians make too much to get this credit. In 2014, this credit is phased out at an AGI of $75,000-95,000 ($110,000-130,000 married.) Although it is based on a modified AGI, if you can't deduct student loan interest, you probably can't get the child tax credit. For the poor (like medical students) who don't pay taxes or even have negative taxes, there is even an additional child tax credit, which is refundable.

Using Your Kid's Tax Brackets

There is some big savings available by using your childrens' tax brackets. Just like in retirement when you want to "fill-up" the 0%, 10%, and 15% brackets with IRA/401(k) withdrawals, during your career it would be best (from an overall family wealth perspective) to fill up everyone's 0%, 10%, and 15% brackets. How big are these brackets for your children? Well, it depends on whether it is earned or unearned income. Earned

income is best, since the 0% bracket (standard deduction) is $6,200, the 10% bracket is $18,150, and the 15% bracket is another $55,650. However, it is pretty tough for a kid to earn that much.

Unearned (investment) income can also be useful, but the standard deduction (0% tax bracket) is tiny, just $1,000. There is a 10% bracket, another $1,000, but above that their unearned income is taxed at your maximum rate, not a good thing.

So if you have four children, and can shift $24,350 in earned income and $2,000 in unearned income to each of them, the total tax bill on that $105,400 would be $7,660. If that money were all taxed at your 33% rate, the bill would be $34,782. Shifting the income saves you $27,122. But wait, it gets even better. The savings might not be quite that much, since your children would have to pay payroll taxes on their earned income, but you get the point.

Hiring Your Kids

How can you shift income? It’s very easy to shift unearned income, that’s why the brackets are so tiny. Shifting earned income is more difficult- your business needs to hire your kids. They can work for your clinic, your website, your rental property etc. You don’t have to hire them as employees; you can also contract with them as independent contractors. They obtain work experience, they earn some spending money, and the overall family tax bill is lowered. You can go one step further and contribute those earnings to a Roth IRA, establishing important saving and investing habits early. Imagine Roth money that is invested for 6 or 7 decades before being spent! The kid might not be interested in using his hard earned cash for retirement, but money is fungible. You can “match” his earnings, giving him what he earns as a gift while putting the earnings into the Roth IRA.

"But my kid is too young to work," you say. Not necessarily. You've seen all those pictures of kids in magazines, catalogs, and on the internet. Why shouldn't they be paid a modeling fee for their effort? What's a fair modeling fee anyway? Surely your kids are so pretty they should command a hefty sum. Don't get carried away. Remember you may have to justify the sum to an auditor someday. (It turns out $300 a day is probably a reasonable sum. $3000 a day probably isn't.) Don't be surprised if you start seeing more pictures of my kids on this website.

UGMA/UTMA Accounts

The way to shift unearned income to your children is to give them the money by investing it in a UGMA/UTMA account. This probably isn't the place to put college money, 529s and ESAs are probably better for that in most instances. But for money you would like to give your kids anyway, to help with a down payment, a mission, buying their first car, a wedding etc, an UGMA (Uniform Gift to Minors Account) or UTMA (Uniform Transfer to Minors Account) is the perfect choice. There are slight differences between the accounts (the UTMA is a little more flexible) and they are governed by state law, but in general the basic concept is that you control the money until the child turns 18-25, and the kid can blow the money on whatever he wants.

In exchange for using that account, the earnings are taxed at the kid's rate. That means the first $1,000 in earnings is tax-free, and the second $1,000 in earnings is taxed at just 10%. Any earnings above $2,000 is taxed at your rate, the infamous "kiddie tax." But $2,000 in earnings is a heck of a lot if the account is invested in a very tax-efficient manner. Consider an index fund which kicks off 2% a year in long-term capital gains and qualified dividends. You could have $100K in this account before any of it is going to be taxed at your rate. If you have more than that, you can start investing it

in I bonds, zero coupon bonds, or even a municipal bond fund. When your child is in his 20s, and probably in a very low tax bracket, he may not even have to pay long-term capital gains taxes upon withdrawal! (Remember that the LTCG tax rate for those in the 10% and 15% bracket is 0% these days.)

Tax Loss Harvesting

You can even tax loss harvest and tax gain harvest these accounts. I've been carrying a $400 loss forward for years in my daughter's account. One year I even "updated the basis" by harvesting some gains (but less than $1000 so it was a tax-free update.) I'm not sure the tax gain harvest is really worth it if current law remains in place, since I anticipate it will all be withdrawn tax-free anyway in her 20s, but it certainly didn't hurt.

If you are facing what seems to be an unfair amount of taxes, consider doing some multi-generational tax planning, and take advantage of your childrens' low tax brackets to lower your own taxes.

Have you hired your children? Do you use UGMA/UTMA accounts? Why or why not? What pitfalls have you run into? Comment below!