Dynamic Chiropractic

YOUR PRACTICE / BUSINESS

Tax Potpourri

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DEFRA, ERISA, TEFRA -- no these aren't the names of the President's grandchildren. These are just some of the names of changes in the tax laws. Each year there is a new tax law and a new set of initials to learn, and the way things are going, don't be too surprised to see another change early in the 90s. "Read my lips," it will happen. With that in mind, you must take full advantage of all the deductions available to you under the law.

Let's begin our discussion with my favorite subject, the so-called "kiddie tax." Children under age 14 must pay taxes on their "unearned" income above a certain amount at their parents' marginal rate. This applies to unearned income over $1,000. It does not, I repeat, does not apply to "earned" income. Earned income is all compensation for personal services actually rendered. Children are taxed at their own rate on reasonable compensation for services. In other words, you could "hire" your kids to work in your office to do filing, typing, and general "go-for" work, pay them a reasonable salary, and it would be taxed to them at their rate, and not added to your top tax rate. The key words are reasonable rate. In other words, I think you would have a lot of trouble justifying an income to your 7-year-old of $15,000 per year for filing. Paying a 10 to 12-year-old a "reasonable" amount to do filing and general office work would probably fly.

What about kids over age 14? No kiddie tax to worry about. How about paying that 14-year-old up to $7,100 per year and have no income taxes to pay on the total amount? The first thing is to make sure that the child is doing enough work to justify the amount being paid. With that out of the way, here's how it works: $2,000 of the $7,100 is put into an IRA in the child's name. The $5,100 balance requires no tax return to be filed, assuming that your child uses the personal exemption and you don't claim him. You give up the exemption which will cost you about $650. What do you gain for it? If you "cut" your income by $7,100, you save in taxes $2,343. Even subtracting the additional tax by losing the exemption, you are still ahead by almost $1,700 per year. The money that your child puts into an IRA accumulates on a tax-deferred basis. Not bad.

When your child gets ready to go to college, he will have $20,400 plus interest, and in his IRA he will have $8,000 plus interest, for a total of $28,400 plus interest. That has cost you in additional taxes due to the loss of an exemption, $2,600. Not a bad trade-off. By the way, I'm assuming that your child will "tap" his IRA and use that money for college. At that point he will have to pay tax on that money plus a 10% penalty. If you pull out $2,000 per year for 4 years, the total tax would be $500 per year for a total of $2,000. Still way ahead of the game.

By the way, there is no reason why you can't continue to pay your child for work done at a reasonable rate. You could still continue to pay them up to $5,100 per year with no income tax liability on his part. So to summarize, if you followed this scenario from age 14 until he graduates 8 years later, it would cost you in taxes for the lost exemption, $5,200. The tax on the IRA would cost $2,000. Your child would have received a total of $48,800 plus interest. The main question is would you spend $7,200 to gain $48,800? Let's not forget the income taxes that you saved by shifting income to your child. The first 4 years would save you a total of $9,372. The next 4 would save you $6,732 for a grand total of $16,104. Now the question is would you "spend" $7,200 to get tax savings of $16,104, and have $48,800, plus interest? If you have more than one child you can do this for each one of them. The more the merrier!

I think before I end this a couple of reminders are in order. First, I want to again emphasize the work "reasonable" when considering compensation for your child. Last, but far from least, I hope that with all of the ideas that you read about in this column that you will discuss them with your accountant and attorney, to see if they are worth considering in your specific situation.

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Please include a self-addressed, stamped envelope. Thank you.

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