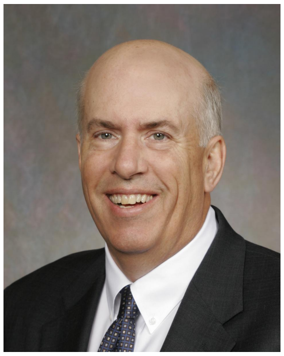

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Gifting Company Stock to Child

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What is it?

If you are an owner of a corporation and plan to sell appreciated stock to pay for your child's education, you may be able to shift the resulting capital gain into a lower tax bracket by gifting the stock to your child and allowing him or her to sell it. Your child can then use the sale proceeds to pay college expenses. However, this strategy may have gift tax implications.

Caution: *The kiddie tax rules may make gifting assets to children less effective as a college savings strategy.*

If you're in the 25, 28, 33, or 35 percent marginal income tax brackets, then a 15 percent tax rate on long-term capital gains generally applies (for individuals in the 39.6 percent tax bracket, a 20 percent tax rate on long-term capital gains generally applies). Individuals in the 10 and 15 percent marginal tax brackets, however, will generally pay no capital gains tax. If you gift appreciated stock to your child, your child will have the same basis and holding period in the stock that you had.

Example(s): *Hal owns 100 percent of the shares in Rock, Inc. Hal is in the 33 percent tax bracket. His son, Bob, plans to attend Central College. Hal decides to sell some of his stock and use the proceeds to pay Bob's tuition and expenses. He sells $10,000 worth of stock to a friend. Hal's basis in the stock is $2,000. Hal realizes a long-term capital gain of $8,000 on the transaction and this gain is taxed at a rate of 15 percent, resulting in a tax liability of $1,200. After taxes, Hal is left with $8,800 to give to Bob for college.*

Example(s): *Jane owns 100 percent of the shares in Stone, Inc. Jane is in the 33 percent tax bracket. Her child, Liz, plans to attend Central College. Jane gifts Liz $10,000 worth of stock. Jane's basis in the stock is $2,000, which becomes Liz's basis. Liz immediately sells the stock to a friend and realizes a capital gain of $8,000. Assuming Liz is in the 10 percent tax bracket, then according to the capital gains tax rates and the kiddie tax rules, the first $2,100 of gain would be tax free (the first $1,050 is tax free and the next $1,050 is taxed at Liz's rate, which is zero percent) and the remaining $5,900 would be taxed at Jane's rate, which is 15 percent, resulting in a tax liability of $885. After taxes, Liz would be left with $9,115 for college.*

When can it be used?

You own appreciated stock in your business

This strategy can be used by anyone who owns appreciated assets. The discussion here is focused on gifts of appreciated stock in your business.

Your child is in a lower tax bracket than you

It is almost always the case that your child is in a lower tax bracket than you, but there are exceptions.

Strengths

Family receives a tax savings on sale of appreciated stock

Your family will enjoy an overall income tax savings. By gifting stock to your child and allowing him or her to sell it, the resulting capital gains may be subject to tax at a lower rate. In the end, more of the sale proceeds will go to education expenses and less will go to paying income taxes.

Tradeoffs

The kiddie tax may limit your tax savings

Special rules commonly referred to as the " kiddie tax " rules apply when a child has unearned income (for example, investment income) over a certain amount (currently $2,100). Children subject to the kiddie tax are generally taxed at their parents' rate on any unearned income over $2,100 (the first $1,050 is tax free and the next $1,050 is taxed at the child's rate).

The kiddie tax rules apply to: children under age 18, children age 18 whose earned income doesn't exceed one-half of their support, and children ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support. These rules could sharply curtail the amount of tax savings available from transferring company stock to your child prior to a sale.

Transferring assets to your child may reduce his or her financial aid award

If your child is seeking financial aid, this strategy could reduce his or her award. Under the federal government's methodology for determining need, a child's assets are weighed more heavily than those of the parents. Accordingly, most experts recommend that your child hold few assets in his or her name as of the date the financial aid application is completed. Whether your child is holding appreciated stock as an asset, or sale proceeds in a savings account, his or her financial aid award could be affected.

Tip: *One way to avoid this outcome is for your child to spend the sale proceeds on college necessities (e.g., car, computer) in the year before the financial aid application is completed. Once the money is spent, it is no longer counted as an asset.*

Tip: *Your child might also transfer the money back to you so that you can set up a college fund in your name. The money will still be used for college, but it will not be considered your child's asset for purposes of calculating federal financial aid.*

Caution: *Seek the advice of an attorney and tax advisor when structuring this kind of transfer. You want to ensure that it is not deemed a sham transaction by the IRS.*

It may be difficult to find a market for stock in your closely held business

If you own stock in a publicly traded company that has appreciated, you or your child should have no problem finding a market for the shares

However, if you own stock in a closely held business and gift it to your child, your child may have difficulty finding a market for the shares. If you identify a buyer prior to making the gift (Uncle Harry or Sister Meg, for example), the transaction could be deemed a sham by the IRS. If you allow your child to sell the stock on his or her own, he or she may have limited success. Furthermore, the stock might be sold outside your circle of family and friends. The family may save a few dollars on income tax, but ends up sharing ownership of the business with a stranger.

The gift tax may limit your tax savings

Transfers of stock to your child are subject to gift tax. The first $14,000 per child, or $28,000 for spouses who are U.S. citizens and make the gift jointly, is exempt from federal gift tax, although you still may owe state gift tax. Larger gifts could result in an overall tax loss.

Child is in control once the transfer is made

You love your child. You want your child to get a good education. You want to fund college expenses in a sensible way. However, once the transfer of stock is made, there is no way that you can force your child to sell the stock and use the proceeds to fund an education. A particularly knowledgeable or manipulative child could take the money and head to the Canary Islands.

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