VEDDER PRICE

Tax & Estate Planning Bulletin

November 2007

This issue addresses two federal income tax provisions that provide potential tax saving opportunities if acted upon before the end of the year.

Kiddie Tax to Reach Adult Children

Parents in high income tax brackets have long tried to shift unearned income such as interest and dividends to children in lower brackets to achieve overall income tax savings for the family. Congress first sought to curtail this perceived abuse in 1986 by passing a law commonly known as the "kiddie tax." Under the kiddie tax, the federal income tax on a child's net unearned income (unearned income in excess of an inflation-adjusted amount) is determined as if such income were earned by the child's parents, if this results in a higher federal income tax. The recently enacted Small Business and Work Opportunity Tax Act of 2007 extends the reach of this tax to older children and certain children who are full-time students.

The prior version of the kiddie tax provided that a child's unearned income in excess of $1,700 (adjusted for inflation) was taxed at the parents' tax rate if the child (1) had not reached age 18 by the end of the tax year, (2) had at least one parent living at the end of the tax year and (3) did not file a joint tax return. For tax years beginning after May 25, 2007 (for most people, this means 2008 and subsequent years), the kiddie tax applies to a child who has not reached age 19 by the end of the calendar year in which the tax year of the parents begins. More significantly, the kiddie tax now also applies to a child who has not reached age 24 by the end of such calendar year if the child is a full-time student and does not provide more than one-half of his or her own support from his or her own earned income. The rules relating to the unearned income threshold, living parents and joint tax returns remain unchanged.

Parents seeking to avoid the consequences of the amended kiddie tax may wish to consider alternative investment strategies. For example, parents contemplating the transfer of investments to children who are subject to the kiddie tax may want to consider investments that produce long-term capital gains or investments that generate little or no current taxable income, such as tax-exempt municipal bonds, unimproved land, or stocks or mutual funds that pay few, if any, dividends.

If a child holds investments and exceeds the age threshold this year, but will be subject to the kiddie tax when the new age limits go into effect for 2008, he or she may want to consider selling assets that have been held for more than one year to take advantage of the low federal income tax rate (as low as 5 percent) on long-term

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capital gains in 2007. You can even give such a child appreciated investments to sell in 2007, so gain will be taxed at the lower rate. However, beware of the federal gift tax consequences if you do this. Parents also may want to consider a section 529 plan if the child plans to attend college. Investment income on assets in a section 529 plan is not subject to federal income tax, including the kiddie tax.

Last Chance to Take Advantage of Tax Break for Charitable Giving through S Corporations

The Pension Protection Act of 2006 (the "PPA") included a taxpayer-favorable provision that makes charitable contributions of appreciated property through S corporations more appealing. However, this provision is only temporary and is set to expire at the end of the 2007 tax year. Consequently, S corporations and their owners should consider taking advantage of this provision by making charitable contributions prior to the end of the 2007 tax year, which for many taxpayers ends on December 31, 2007.

Charitable Giving through S Corporations and Prior Law

As a general matter, S corporations do not claim deductions for their charitable contributions; rather, like other items of income, loss, deduction or credit, charitable contributions made by an S corporation are reported as contributions on the shareholders' federal income tax returns. With some exceptions, if a taxpayer makes a charitable contribution of property, the taxpayer is treated as making a contribution equal to the contributed property's fair market value as of the time of contribution. Thus, if an S corporation (the "contributing corporation") makes a charitable contribution of property, then (subject to certain limitations) each of the contributing corporation's shareholders will take into account his or her pro rata share of the contribution for purposes of determining his or her charitable contribution deduction. Essentially, each shareholder is treated as directly making the charitable contribution to the extent of his or her pro rata share. A shareholder's pro rata share is based on the shareholder's actual ownership interest in the contributing corporation.

Prior to the enactment of the PPA, the applicable federal tax laws required each shareholder of a contributing corporation making a charitable contribution of appreciable property to decrease his or her tax basis in the stock he or she owned in the contributing corporation by the amount of the shareholder's pro rata share of the contributed property's fair market value. For example, assume that Corporation X, an S corporation, is owned 50 percent by A and 50 percent by B and that each of A and B has sufficient tax basis in his or her Corporation X stock to absorb the amount of any charitable contribution that may flow through from Corporation X. Assume further that Corporation X wants to donate property that it owns to A's and B's favorite charity. Corporation X decides to donate property Z. At the time of the donation, property Z has a fair market value of $100 and Corporation X has a tax basis in property Z of $20. Under prior tax law, upon Corporation X's donation of property Z, $50 worth of charitable contribution would flow through to each of A and B, and A and B would each decrease their respective basis in their Corporation X stock by $50.

Temporary Change

Under the temporary provision contained in the PPA, the federal tax law now requires each shareholder of the contributing corporation to decrease his or her tax basis in the stock of the contributing corporation by only his or her pro rata share of the contributed property's adjusted tax basis, as opposed to its fair market value. Returning to the above example, upon the donation of property Z, a $100 contribution would flow through to A and B ($50 to each); however, because Corporation X has a tax basis of $20 in property Z as of the time of contribution, A and B are required to decrease their respective basis in their shares by only $10. Both A and B would receive a greater benefit if, for example, the contributing corporation had a $0 basis in the contributed property because, in that case, neither A nor B would have to decrease his or her

stock basis. In the above circumstances, the temporary change in the law allows both A and B to retain more basis in their shares of Corporation X stock. This means that they may have a greater ability to shelter future income that may arise from the sale of their shares and/or utilize additional items of loss or deduction that flow through from Corporation X.

Of course, taxpayers who make charitable contributions of property generally are required to substantiate the fair market value of the property by satisfying certain appraisal requirements. Also, as noted above, there are various rules that may limit the amount of charitable deductions an individual can take on his or her individual tax return. Additional rules can apply that may also affect the amount of the actual deduction depending on the type of property being contributed.

As noted above, this taxpayer-favorable provision expires at the end of the 2007 tax year. Therefore, you should contact your tax adviser well in advance of the end of the 2007 tax year if you wish to take advantage of this temporary provision.

For additional information regarding this newsletter or any other tax-related matters, please contact a member of Vedder Price's Tax & Estate Planning Practice Group.

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The Vedder Price Tax & Estate Planning Group

Business Tax Planning & Controversy

Due to the complexity and constantly changing nature of the federal, state and local tax laws, the tax aspects of almost every type of business and personal transaction require scrutiny by a tax attorney. At Vedder, Price, Kaufman & Kammholz, P.C., this experience is provided by the members of the tax group, each of whom has had substantial formal tax education, including in some cases advanced degrees in taxation, as well as practical experience in resolving tax problems.

In addition to advising the firm's business clients with respect to the tax issues involved in the everyday operation of a corporation, limited liability company, partnership or sole proprietorship, Vedder Price's tax attorneys plan for and provide advice on the tax aspects of taxable and nontaxable acquisitions of business entities, mergers, recapitalizations, the organization and liquidation of entities, taxable and nontaxable sales and exchanges of assets, foreign operations, redemptions, distributions, and the public and private offering of securities.

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The firm represents clients with diverse personal objectives and financial interests, including individuals with large estates, individuals with personal situations requiring special planning, owners of closely held businesses, corporate executives and professionals. Vedder Price's Estate and Financial Planning attorneys also represent executors, administrators, trustees and guardians. In addition, the firm provides estate and financial planning counsel to businesses and not-for-profit organizations, as well as other professionals who consult Vedder Price with respect to their own clients.

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