Income shifting is designed to deflect taxable income from one taxpayer to another. The affected taxpayers may be any combination of individuals, corporations, trusts and estates. These strategies make sense only when (1) the transferor has a concern about, or interest in, the financial well-being of the transferee and (2) the transferor is in a higher marginal tax bracket than the transferee.

Income shifting has been affected profoundly by the Tax Reform Act of 1986 (TRA-86). Some of the reasons are straightforward; others are more subtle. The practical consequences of these changes are varied and, in some cases, at least a bit uncertain. In any event, it is clear that every lawyer must re-evaluate the effectiveness and desirability of all income shifting arrangements, including those implemented prior to the effective date(s) of TRA-86.

Brief Historical Background

The assignment of income doctrine has been around for more than 50 years. It generally requires that income be taxed to the person who earned it; that is, the true earner of income cannot shift the tax consequences of that income to another. For many of those years, the great majority of lawyers thought of this doctrine as an effective roadblock to income shifting. Congress, however, provided exceptions (e.g., sections 673 and 351) and clever lawyers figured out attractive detours (e.g., interest-free loans and gift/lease-backs). Eventually, articles in professional journals and speeches at tax institutes routinely trumpeted the opportunities as well as the means. They emphasized that many income shifting opportunities were available and that they were not just for the daring. The result was a virtual explosion in the use of both conservative and aggressive income shifting techniques.

Tax Reform Leading Up to TRA-86

For a variety of reasons, a particular income shifting device, the interest-free loan, was especially “hot” during the early 1980’s. Tax reformers fumed at the notion that such a simple and relatively painless device could be used so effectively. So they rolled up their sleeves and went after interest-free loans. Their efforts lead to the adoption of IRC section 7872 which “plugged” this “loophole.”

When the Treasury’s report on simplification and reform was issued later that same year, lawyers realized the reformers were not satisfied with the elimination of one specific device. They now had targeted the whole area of income shifting. The report made no secret of the reformers’ contempt for income shifting. For example, in the section dealing with income shifting from parents to children, the report not only stated that such strategies “undermine the progressive rate structure and [are] a source of unfairness,” but also listed this area under “tax abuses.” The use of such a charged expression surprised many observers who were used to hearing that term used in connection with gross over-valuations that amounted to nothing more than sophisticated fraud, mail-order ministries, constitutional or “family” trusts and frivolous positions of tax protesters. By labeling income shifting a “tax abuse,” reformers within the Treasury certainly made it clear they wanted to whack the whole area and whack it hard.

TRA-86 Eliminates Certain Specific Devices

TRA-86 eliminated Clifford trusts funded after March 1, 1986, from the list of effective income shifting strategies. It did so by providing, in IRC section 673, that if either income or principal may revert to the grantor and the value of that reversion is initially in
excess of 5% of the value of the trust (or portion that reverts), the grantor will be taxed on the income from the trust (or portion that reverts).

Spousal remainder trusts similarly were eliminated. This was done by providing in IRC section 672(e) that the grantor shall be treated as holding any interest held by the grantor's spouse.

Like interest-free loans, Clifford and spousal remainder trusts had been especially attractive intra-family shifting devices because they could be used to shift income without making a permanent transfer of income-producing property. Given a choice, most high-bracket parents prefer to shift the "fruit" without giving up the "tree." It is for this reason that the loss of Clifford trusts and spousal remainder trusts, like the earlier loss of interest-free loans, will make income shifting less attractive.

**Trust Tax Bracket Compression**

Of course trusts still can be used to shift income as long as the new 5% reversion rule is not violated. In fact, if some but not all trust income is distributed (or deemed distributed) to a low-bracket beneficiary, the trust's income can be split between the trust and the beneficiary. The resulting run up to separate tax rate schedules can magnify the total tax savings. This is attractive primarily for years prior to the beneficiary's 21st birthday because of an exception to the throwback rule that applies in such cases.

TRA-86 did not eliminate the trust as a low-bracket participant in income shifting arrangements, but it did reduce the potential savings. By compressing the tax brackets of all trusts and including a phase-out of the benefit of the low bracket, TRA-86 has limited the potential tax savings. Generally, there is no longer an advantage to having more than $5,000 of income taxed to the trust itself.

**General Tax Bracket Compression**

Income shifting can be attractive only in a progressive, rather than flat, tax system. The greater the possible range between the brackets of high-bracket taxpayers and those of low-bracket taxpayers, the greater the possible savings from income shifting.

TRA-86 did not provide a "flat tax system" but it did compress the rates of both individual and entities significantly. Since the maximum rates have come down, the incentive to shift income has been reduced. Individuals in a maximum bracket of 28% or 33% (rather than 50%) simply cannot save as much in taxes now by shifting income to other individuals or entities.

**The New "Kiddie Tax"**

Many Clifford trusts and spousal remainder trusts that were funded prior to March 2, 1986, and therefore not adversely affected by the above-described amendments to sections 672 and 673, may be far less effective in the future. The primary reason for this is the enactment of the new "kiddie tax" provisions. In a nutshell, a child under the age of 14 will continue to be taxed on his or her income, but unearned income in excess of $1,000 will generate a tax equal to what that child's parent(s) would have paid on that amount of additional income. The child's first $500 of unearned income generally will be offset by that much of the standard deduction, and the second $500 generally will be taxed to the child at his or her own marginal bracket. So, while some parents still can accomplish tax savings by shifting $1,000 of unearned income to a child under the age of 14, the amount that can be saved by using a young child as a taxpayer has been reduced greatly. Keep in mind that these so-called kiddie tax rules apply regardless of when the income shifting arrangement was put into place. So, for example, even a Clifford trust that has been grandfathered as a shifting device probably will be far less effective in the future during such time as one or more of the beneficiaries is under 14.
Personal Exemptions/Dependency Deductions

The amount of each personal exemption/dependency deduction has been practically doubled. However, this will have little or no significance to many parents of dependent children. For starters, beginning this year, anyone who can be claimed as a dependent on another's return will not be allowed a personal exemption on his or her own return. Furthermore, after this year, high-income parents may not get the benefit of otherwise available dependency deductions. Dependency deductions will be phased out (via a 5% surtax) as taxable income goes beyond a certain point. The result is that some parents who have benefited from dependency deductions on their returns and personal exemptions on their children's returns will enjoy the benefit of neither in future years.

Shift to Corporations

It has been fairly commonplace that income would be shifted from a shareholder's maximum bracket to his or her closely held corporation's low brackets. The threat of double taxation was not much of a deterrent. The second tax might never be incurred (because of a stepped-up basis at death). More importantly, the time value of money combined with the prospect of a long-term capital gain deduction (i.e., deferral and conversion) make that form of double taxation more attractive than the alternative form of single taxation.

TRA-86 drastically alters the attractiveness of corporations as low-bracket participants in income shifting arrangements. First, the phase-out of a corporation's low brackets kicks in much sooner than before. Second, preferential treatment of long-term capital gain virtually has been eliminated. Finally, the complete repeal of the General Utilities doctrine ensures that "inside" appreciation eventually will be subject to corporate taxation.

"Gray Area" Income Shifting

While it is true that income shifting has not been just for the daring, a number of strategies have evoked at least some degree of doubt as to their validity. These strategies (e.g., gift/leasebacks, gift/borrowbacks, gift/buybacks, undercompensated high-bracket taxpayers, special allocations in family partnerships, gifts of inventory items to donees who sell them as capital assets, high-interest loans from low-bracket taxpayers, etc.) now involve a greater "downside risk." A deficiency on audit will result in interest that will be at least partly non-deductible and, depending on many variables, a deficiency could lead to a section 6661 penalty that would be 250% greater than what was applicable prior to October 22, 1986.

With the upside potential coming down and the downside risk going up, many lawyers and their clients surely will decide that venturing into the gray area no longer makes sense.

What's Left

Unquestionably, income shifting is not what it used to be. Congress whacked this area of tax planning with as much or more force than any other area. Nevertheless, income shifting is not dead.

Keep in mind that children over the age of 13 are not subject to the new kiddie tax. Parents who can afford to make a gift of income-producing property may continue to be good candidates for non-Clifford trusts or custodial (or similar) arrangements. If, for example, a parent in a 33% federal bracket shifts income to a child in a 15% federal bracket, total taxes can be more than halved! A child who is 14 or older will not go beyond the 15% bracket until his or her taxable income exceeds $17,850 ($16,800 in 1987). If the trust itself is used as a low-bracket taxpayer, another $5,000 of income can be sheltered at 15%.

Children who have not yet reached the age of 14 continue to be low-bracket taxpayers with respect to as much as $1,000 of their unearned income and all of their earned income. By investing all the funds held for the benefit of a young child in something like E bonds or growth stock, recognition of unearned income can be delayed until the child has reached the age of 14. A child of any age may be able to generate at least some earned income by performing valuable services in a context where the parent will be entitled to a deduction. Documentation is important; reasonableness is essential.

Reform legislation has made it increasingly difficult to shift income without permanently giving up valuable income-producing property with a basis representing after-tax value. In an income shifting context, parents generally prefer to give up only before-tax value. It still may be possible to limit the gift to before-tax value by limiting the gift to zero-basis property (which few parents have) or, more importantly, by selling appreciated property to the child (or to his or her trustee custodian) for consideration equal to the parent's basis. Such bargain sales are not necessarily simple strategies and therefore require careful analysis in each case.

Income from closely held pass-through entities continues to be taxable to the owners of equity interests in those entities. Consequently, the transfer of a partnership interest or stock in an S corporation directly or indirectly to a low-bracket taxpayer still can facilitate the shifting of income. Again, like most other shifting mechanisms, this is potentially complex and must be approached with care.

Conclusion

The art of income shifting has been affected drastically by TRA-86. The canvas is now smaller and the colors limited. Lawyers still can create interesting income shifting strategies, but the value of such planning has eroded to the point that this previously active area is now of questionable value to the vast majority of taxpayers.

Randall W. Roth is a professor at the University of Hawaii and is of counsel to Goodsell, Anderson, Quinn & Stiffel in Hawaii.