Shifting Income/Timing Income: Tax Planning for the Self-Employed

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What is shifting income/timing income?

Income shifting (also known as income splitting) may be defined as dividing income in a way that lowers overall taxes. Typically, income is shifted from higher-bracket taxpayers to lower ones. Income shifting can be a valuable tool for self-employed persons.

Although there are a number of ways to accomplish a shifting of income, the following methods are most popular: employing family members, family partnerships, interest-free and below-market loans, gifting, sale- or gift-leaseback, trusts and life insurance/annuities. When using these methods to shift income to a child, it's always important to bear in mind the kiddie tax.

Timing the receipt of your income can also help you lower your taxes. When tax rates are stable, it's wise for you to defer as much income as possible from one year to a later year and to accelerate deductions so that you can postpone payment of the tax. When you eventually realize the income at some future point, it's possible that you'll be retired and/or in a lower tax bracket. Understanding the differences between the cash method and the accrual method of accounting can also help you to time your income most effectively.

What is the kiddie tax, and what is its relation to income splitting?

In the past, parents found that they could lower their taxes by shifting unearned income into their children's names. This worked because the parents were in a higher tax bracket than their children. Congress closed this loophole by enacting certain rules known as the kiddie tax.

The kiddie tax rules apply when a child has unearned income (for example, investment income). Children subject to the kiddie tax are generally taxed at the parents' tax rates on any unearned income over a certain amount. In 2023, this amount is $2,500 (the first $1,250 is tax free and the next $1,250 is taxed at the child's rate). The kiddie tax rules apply to (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support.

How can employing your family members help you to shift income?

One method of income shifting is to hire your family members to work in your business. Paying salaries to family members reduces the amount of business income that you must pay yourself. In addition, the tax code provides a particular Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) tax exclusion for unincorporated businesses that employ an owner's children. The earnings of a child under 18, who is employed by a parent owning a sole proprietorship or a partnership, are not subject to FICA (Social Security and Medicare taxes). Likewise, there is an exclusion from FUTA (unemployment tax) for a business paying the owner's child who is under age 21. Of course, you'll have to ensure that the type of work performed, the rate of pay and the timing of payment are all appropriate.

How can income be split among family members in a family partnership to reduce overall taxes?

Limited partnerships can be used to split income taxes. A family limited partnership (FLP) is owned by family members and operates under the rules of limited partnerships. Typically, parents form an FLP and transfer their assets (e.g., an existing business) to this entity.

The FLP is used to shift present business income to lower-bracket family members. The children have no right to manage the business; rather, they are treated like investors who have an ownership interest only in the business. Each child can receive limited partnership interests worth

$17,000 (the annual gift tax exclusion amount in 2023) from each parent as gifts, without federal gift tax consequences. Thus, income generated by the business will pass through to a number of different family members. In addition, limited partners can work in the business and be compensated for their services. Be aware, however, that the IRS has expressed some concerns regarding the gifting of FLP interests.

How can gifts be used to shift income?

Gifting assets to family members is another way to shift income. It might be advantageous for you to gift income-producing investment assets (such as stock in various companies) to your relatives. The initial distribution of shares to your relatives would be classified as a gift, and the annual income from the gift would be taxed to the relative. You can make federal gift tax-free gifts of up to $17,000 per year per recipient under the annual gift tax exclusion in 2023. Married couples can generally double that amount if they split the gifts. If your gift exceeds the annual exclusion amount, the excess may be subject to gift tax. However, gift tax due may be offset by your $12,920,000 (in 2023, $12,060,000 in 2022) basic (applicable) exclusion amount if it is available.

You should also be aware of the Uniform Transfers to Minors Act (UTMA) and the Uniform Gifts to Minors Act (UGMA). Some states don't allow securities to be registered in a minor's name. Basically, if you want to transfer an income-producing asset to a minor child, you have two choices: to make the gift under UTMA or UGMA or to make the gift in trust.

How can interest-free and below-market loans be used to shift income?

Another way for a family to shift income is to use a no-interest or low-interest loan to a family member as an alternative to an outright gift. Low interest means that the rate of interest charged is less than the applicable federal rate (AFR) set monthly by the IRS. In general, the IRS will impute interest (i.e., treat you as if you had received interest at the AFR) if you loan money without charging at least the AFR. However, there are some exceptions to this rule. In general, de minimis loans (those that are $10,000 or less) will not result in imputed interest or reclassification as a taxable gift. Also, if certain conditions are met, loans of less than $100,000 will not cause interest to be imputed.

How can trusts be used to shift income?

You can transfer income-producing assets or cash into a trust for the benefit of someone else. If the trust is set up properly, income that is paid out of the trust to a beneficiary will be taxed to the beneficiary rather than to you. Thus, the trust may be used as an income-shifting tool. Many different forms of trusts exist, and you must be careful to avoid grantor trust arrangements, whereby trust income is taxed to the grantor rather than to the beneficiary. Grantor trusts usually are not used for income shifting, although they have many other uses.

How can annuities and life insurance be used to reduce income taxes and shift income?

Rather than invest all of your cash in income-producing assets that create taxable income in the current year, you can purchase an annuity to reduce income taxes; this is because the income generated by the annuity will accumulate tax free until the funds are withdrawn. The interest is not taxable in the current year as long as no withdrawals are made. In addition, if the annuity payouts will begin when you are much older, you may be in a lower tax bracket at that time.

You can also invest some of your cash in a life insurance policy, naming a relative as the beneficiary and/or owner. In this way, you can also shift income, and the cash value of the policy grows tax deferred.

How can a sale- or gift-leaseback be used to shift income?

Another way to shift income is to transfer property (such as a vacation home) by using a sale- or gift-leaseback arrangement. Typically, you would sell the property to a relative and then rent it back from the relative. Potentially, the lessor would get depreciation benefits as well as rental income.

What about the timing of income?

Timing your income appropriately can also help you to lower your taxes. Self-employed persons should know the difference between the cash method of accounting and the accrual method of accounting. It is also useful to know about postponing (deferring) income and accelerating deductions.

Cash versus accrual method of accounting
Essentially, using the cash method of accounting means that your business will recognize revenues and expenses only when there is an actual inflow or outflow of cash with respect to your business.

Example(s): Assume John Smith began a sole proprietorship, the Smith Barbershop, on Dec. 31, 2022. His fiscal year also ends on Dec. 31. Smith has three customers on Dec. 31, and each receives a $20 haircut. Two of the customers pay Smith in cash, and one customer tells Smith he'll be back with a $20 bill the next day. Smith hands the third customer a bill to remind him of the debt. Because Smith uses the cash method of accounting, he informs the IRS that he earned $40 for 2022.

Example(s): If, however, John's business used the accrual method of accounting, he would have to report $60 worth of income to the IRS for 2022. That's because John completely performed his end of the haircutting contract and is owed an additional $20 for work performed during 2022.

The accrual method of accounting, then, may be defined as one that recognizes revenue at the point of sale and recognizes expenses when incurred (not simply when paid).

Postponing income and accelerating deductions

When tax rates are stable, it's generally wise to lower your taxable income by postponing your income and accelerating your deductions. For instance, if you're a self-employed taxpayer who uses the cash method of accounting in your business, you should consider delaying the billing of some of your customers until next year. It's not taxable income until you have the cash (or a reasonable substitute) in hand.

If, however, you use the accrual method of accounting in your business, you should defer your right to receive payment for the goods or services you provide. You can accomplish this by waiting until next year to finish a job or by holding up your delivery of goods until next year.

You can accelerate deductions by incurring (or paying) deductible expenses late this year instead of early next year.