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Planning for Kiddie Tax

The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 changes the rates at which a child's unearned income is taxed. Instead of being subject to the compressed trust and estate brackets, a child's unearned income is now subject to the parents' marginal rate.

Background

The "kiddie tax" is designed to prevent parents from shifting income from their own higher tax bracket to a child's lower tax bracket. The kiddie tax applies to certain children who have unearned income above a specified amount ($2,100 in 2018 and $2,200 in 2019 & 2020, indexed for inflation).

To be subject to the kiddie tax, a child must be either (1) under the age of 18, or (2) a full-time student under the age of 24 who receives at least half of her support from a parent. In addition, the kiddie tax only applies if at least one of the child's parents is alive and the child does not file a joint tax return.

The kiddie tax only applies to unearned income. It does not apply to earned income such as salary, wages, and compensation for services. Unearned income includes interest, dividends, capital gains, capital gain distributions, social security benefits, certain distributions from trusts, and taxable IRA and pension distributions.

Impact of the TCJA & SECURE Act

Before the Tax Cuts and Jobs Act (TCJA) of 2017, the child's tax on unearned income above the specified amount would be determined based on her parents' marginal tax rate. This required the child to understand her parents' tax liability before filing a tax return along with IRS Form 8615. This presented challenges if the parents were divorced or married filing separately, or if the child had siblings who were also subject to kiddie tax. Alternatively, if the child had only interest and dividend income and totaling less than $10,500, the parents could include the child's income on the parents' tax return using IRS Form 8814.

In a move towards simplification, the TCJA changed the kiddie tax calculation. From 2018 through 2025, children subject to the kiddie tax were scheduled to use the trust and estate tax brackets for calculating their tax liability, completely ignoring the parents' tax bracket. This was significant because the threshold at which trust and estate income becomes subject to the top marginal rate is hundreds of thousands of dollars lower than that of individuals and married couples filing jointly. Accordingly, this change resulted in a much higher tax liability than before.

The SECURE Act changed the kiddie tax regime once again. It reverted to using the parents' marginal tax rates for tax years after 2019. For 2018 and 2019, children can elect to use the parents' marginal tax rates rather than the trust and estate rates. Given the timing of the SECURE Act, it's likely that children will file using parents tax rates for 2019, rather than the compressed trust tax brackets. Additionally, children will probably evaluate filing amended returns for 2018 to obtain tax savings.

PLANNING FOR KIDDIE TAX

How It Works

Let's use the example of Edison, a 12-year-old living with his parents. In 2019, he has $3,900 of unearned income: $2,000 of dividends, $1,400 of interest, and $500 of capital gains. Edison does not have any itemized deductions. The kiddie tax applies and $1,700 will be taxed using the parents' tax rates :

Unearned income	$3,900
Less specified amount	$2,200
Net unearned income subject to kiddie tax	$1,700

Planning Ideas to Avoid Kiddie Tax

The following planning ideas avoid application of the kiddie tax. However, keep in mind that tax avoidance should never be the primary reason for selecting a planning strategy. Make sure that the strategy selected always furthers the overall end goal.

1. **Buy tax-exempt assets**. Tax-exempt interest is not included in the kiddie tax calculation. Consider purchasing assets that are generally tax-exempt, such as permanent life insurance and municipal bonds.

2. **Harvest capital losses**. Capital losses reduce unearned income. If capital losses push unearned income below the applicable threshold, the kiddie tax does not apply.

3. **Earn income and contribute to a Roth IRA**. A child of sufficient age and ability may earn income in a variety of ways, including working at a family business, an outside business, or being self-employed (e.g., babysitting, mowing lawns, shoveling snow, etc.). Earned income is excluded from the kiddie tax calculation. Parents can fund a Roth IRA for a child up to the lesser of the child's earned income or $6,000 (2020 figure, indexed for inflation). The parent can control the Roth IRA until the child reaches the age of majority using an UTMA or UGMA custodial ownership. Since Roth accounts grow tax-free, their earnings are not subject to the kiddie tax.

4. **Open a 529 plan or Coverdell**. Both 529 plans and Coverdell education savings accounts provide tax-deferred growth which is not subject to the kiddie tax. Under both plans, a parent generally controls the funds and disbursements. Disbursements are tax-free if used for qualified higher education expenses such as tuition, fees, books, supplies, and equipment.

5. **Avoid full-time student status**. Dependents between ages 18 and 24 are subject to the kiddie tax only if they are a full-time student. If the child is not a full-time student, the kiddie tax does not apply.

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