# The "Kiddie Tax"

Dear Client:

You recently asked how you can save taxes by transferring assets into your children's names.

This tax technique is called income shifting. It seeks to take income out of your higher tax bracket and place it in the lower tax brackets of your children. While some tax savings are available through this approach, the " kiddie tax" rules impose substantial limitations on it if: (1) the child hasn't reached age 18 before the close of the tax year, or (2) the child's earned income doesn't exceed one-half of his support and the child is age 18 or is a full-time student age 19 to 23.

The kiddie tax rules apply to your children who are under the above-described cutoff age, and who have more than a prescribed amount of unearned (investment) income for the tax year-$2,100 for 2016 or 2017. Essentially, these rules tax the child's investment income above this amount (called "net unearned income") at the parents' (higher) tax rate. While some tax savings on up to $2,100 of income for 2016 or 2017 can still be achieved by shifting income to children under the cutoff age, the savings aren't substantial.

The following example shows how the kiddie tax rules work. In reading through it, note that, under the regular tax rules, for 2017 a dependent child cannot claim a personal exemption and is limited to a standard deduction of $1,050 (unless his "earned" income, e.g., from a job, plus $350, exceeds that amount).

*Example*. For 2017, Mr. and Mrs. Smith are in the 25% federal income tax bracket. That is, they would pay $25 in additional tax on every $100 of additional income. The couple are the parents of a 12-year-old son, Tommy, to whom they transfer a $22,000 bond that pays 10%. Tommy therefore receives $2,200 of investment income. He has no other income.

Had the parents kept the bond, they would have paid $550 in tax on the interest ($2,200 × 25%). Tommy, instead, is taxed on $1,150 of taxable income-$2,200 of gross income reduced by his $1,050 standard deduction-as follows. His "net unearned income" is $100 (the excess of his interest income above $2,100). This part of his taxable income is taxed at 25%, for a tax of $25 ($100 × 25%). The rest of Tommy's taxable income, $1,050 ($1,150 – $100) is taxed at his 10% tax rate, for a tax of $105. Tommy's total tax is thus $130 ($25 + $105). Since the parents would have paid $525 on the interest income, the family saves $420 via the tax move.

If Tommy were 19 or older or, if a student, 24 or older, all of his taxable income would be taxed at his own 10% rate. His tax bill on his $1,150 of taxable income would be $115 ($1,150 × 10%). An additional savings of $15.

Note that, to transfer income to a child, you must actually transfer ownership of the asset producing the income: you cannot merely transfer the income itself. In the above example, the parents were careful to give the child the ownership of the bond itself and didn't merely assign the interest payments to him. Property can be transferred to minor children using custodial accounts under the state Uniform Gifts or Transfers to Minors Acts.

The portion of investment income of a child that is taxed at the parents' tax rates under the kiddie tax rules may be reduced or eliminated if the child's investments produce little or no current taxable income. Such investments include:

- securities and mutual funds oriented toward capital growth that produce little or no current income;
- vacant land expected to appreciate in value;
- stock in a closely-held family business, expected to become more valuable as the family business expands, but which pays little or no cash dividends;
- tax-exempt municipal bonds and bond funds;
- U.S. Series EE bonds, for which recognition of income can be deferred until the bonds mature, the bonds are cashed in, or an election to recognize income annually is made.

Investments that produce no taxable income-and which are therefore not subject to the kiddie tax-also include tax-advantaged savings vehicles such as:

- traditional and Roth individual retirement accounts (IRAs and Roth IRAs), which can be established or contributed to if the child has earned income;
- qualified tuition programs (QTPs, also known as "529 plans"); and
- Coverdell education savings accounts ("CESAs").

A child's *earned* income (as opposed to investment income) is taxed at the child's (not the parents') tax rates, regardless of amount. Therefore, to save taxes within the family, consider employing the child and paying reasonable compensation. This is particularly appropriate if you have your own business, but can be done even if

you don't.

Where the kiddie tax applies, it's computed and reported on Form 8615, which is attached to the child's Form 1040.

Parents can elect to include the child's income on their own return, if certain requirements are satisfied. This avoids the need for a separate return for the child, but, generally, doesn't change the tax on the child's unearned income, which is still taxed at the parents' tax rate. However, it's important to consider that the addition of the child's income to the parent's adjusted gross income may affect the various floors and ceilings for, and therefore the amounts of, the parents' deductions and limitations.

The election to include a child's income on the parents' return is made, and the additional taxes resulting to the parents are computed and reported, on Form 8814.

If you have any questions on the above, please call.

Very truly yours,

Cohen & Grieb, P.A.

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