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CHANGES TO THE KIDDIE TAX

By: GLORIA MOORE, CPA

Last December's Tax Law makes some unfriendly changes to the so-called "Kiddie Tax" starting in 2018. The tax is a special levy on a child's "unearned" income above $2,100. It is typically applied to investment income, such as interest, dividends and capital gains. It is not applied to "earned" income from work that is generally reported to the child on a W-2 or 1099-MISC. The tax originally applied to children under 14, but it has been expanded over time to include nearly all children under 18 and many who are under 24, if they are full-time students and do not support themselves.

Prior to 2018, if a child was subject to the Kiddie Tax, the unearned income in excess of $2,100 was taxed at the parents' (higher) tax rate. For the tax years 2018-2025, the Kiddie Tax is computed by applying the ordinary and capital gain rates for estates and trusts. Thus, a child's tax isn't affected by the tax situation of the child's parent or the unearned income of siblings.

Applying the estate and trust rates under the Kiddie Tax rules will generally produce a higher tax bill because the brackets ranges under the estate and trust tax schedule are much smaller than those for individuals. For example, the top 37% income tax rate applies to married joint filers at $600,000 taxable income, but it applies to an estate or trust (and now also under the Kiddie Tax) at $12,500.

Additionally, under the estate and trust rates, capital gains are taxed at 20% once taxable income hits $12,700 versus $479,000 for married filing joint taxpayers.

As an example: Assume a full-time college student has parents with taxable income of $150,000. To help with tuition, the student's grandparent gives him stock to sell that has a long-term capital gain of $40,000. Under 2017's Kiddie Tax, the student would have owed $5,700 because the parents' capital gains rate was 15%. Under the new law, his tax bill will rise to $6,600, because a portion of the gain is now taxed at the top 20%. An alternative might be to give the stock to the parents to sell and report tax on the gain at 15%.

Before parents and grandparents make a generous gift to a young person, they may want to look at the income tax effects for unintended consequences.

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