# 2017 Tax Act Simplifies Kiddie Tax

February 9, 2018 **|** by Gary Botwinick, Matthew Rheingold

The next alert in our weekly series highlighting the major changes to the law as a result of the Tax Cuts and Jobs Act of 2017 (the “Act”) discusses changes to the "Tax for Certain Children Who Have Unearned Income" or the "Kiddie Tax."

Prior to 2018, the “Tax for Certain Children Who Have Unearned Income,” more widely known as the “Kiddie Tax,” required a child’s interest, dividends, capital gains and other unearned income, to the extent it exceeded $2,100, to be taxed at the highest marginal tax rate of the child’s parent. In other words, any unearned income over $2,100 was taxed to the child, but at the rate that would apply as though the income was included on the parents’ return. The purpose of the Kiddie Tax was to discourage parents from engaging in the tax-savings technique of transferring to the children income-producing property that would be subject to the children’s lower income tax rates. The Kiddie Tax did not apply to earned income, i.e., wages or salary paid to the child for the performance of personal services.

Prior to 2018, the manner of computing the Kiddie Tax was a complicated, multi-step process. Under certain circumstances, the parents could avoid this complex calculation by simply electing to include the children’s income on the parents’ return.

## New Tax Law

Under the 2017 Tax Act, the first $2,100 of unearned income is exempt from tax. Once the unearned income exceeds that amount, the tax imposed against such income is based upon a schedule of tax brackets similar to that which is imposed upon trusts and estates, rather than the rate imposed upon the parents’ income. The compressed tax rate schedule for estates and trusts provides a 10% tax rate for the first $2,550 of taxable income above the $2,100 threshold, which can be advantageous for children with low to modest unearned income above $2,100. For children with substantial unearned income, this can be disadvantageous because the tax rate schedule reaches the highest tax rate of 37% when taxable income exceeds $12,500. This may be lower than the parents' income tax bracket. However, the children of high earning parents who are already in the highest bracket, will get the opportunity to utilize lower brackets until they receive unearned income of $14,601.

## Suggested Planning Recommendation #1

The Kiddie Tax will not apply unless the child has unearned income in excess of $2,100 for 2018 (as adjusted for inflation). To minimize or eliminate the Kiddie Tax, parents should invest the child's funds in equities (i.e., stocks) or other non-income producing assets that are more likely to appreciate in value rather than income producing investments such as bonds.

## Suggested Planning Recommendation #2

Parents may transfer assets to certain qualified tuition programs such as 529 college savings plans, Coverdell education savings accounts, and prepaid college tuition programs offered in many states. These programs are not subject to the Kiddie Tax, nor subject to income tax to the extent the assets are used for college and other higher education expenses.

## Suggested Planning Recommendation #3

Keep in mind that only unearned income is subject to the Kiddie Tax. A parent owning a family business might consider employing the child to work in the business. The earned income of the child will not be subject to the Kiddie Tax, and the child may save tax by contributing a portion of the child's earned income to an Individual Retirement Account or to a 401(k) plan, if one is maintained by the family business. The future income from the assets in the IRA or 401(k) will grow tax free until distributed to the child much later. This may result in significant appreciation in value and tax savings for the child's future use. Or, alternatively, the child's income can be invested in a Roth IRA after paying tax at the child's earned income tax rate, allowing these funds to not only grow tax free, but also allow distributions to be made tax free.

The attorneys at Einhorn Barbarito are happy to discuss these and other available tax planning opportunities that can still be employed to reduce your income tax liabilities.

Please contact Einhorn Barbarito for any questions you have regarding the new tax law.