The ‘kiddie tax’ is now easier to calculate, but more expensive for some children

By Bill Bischoff
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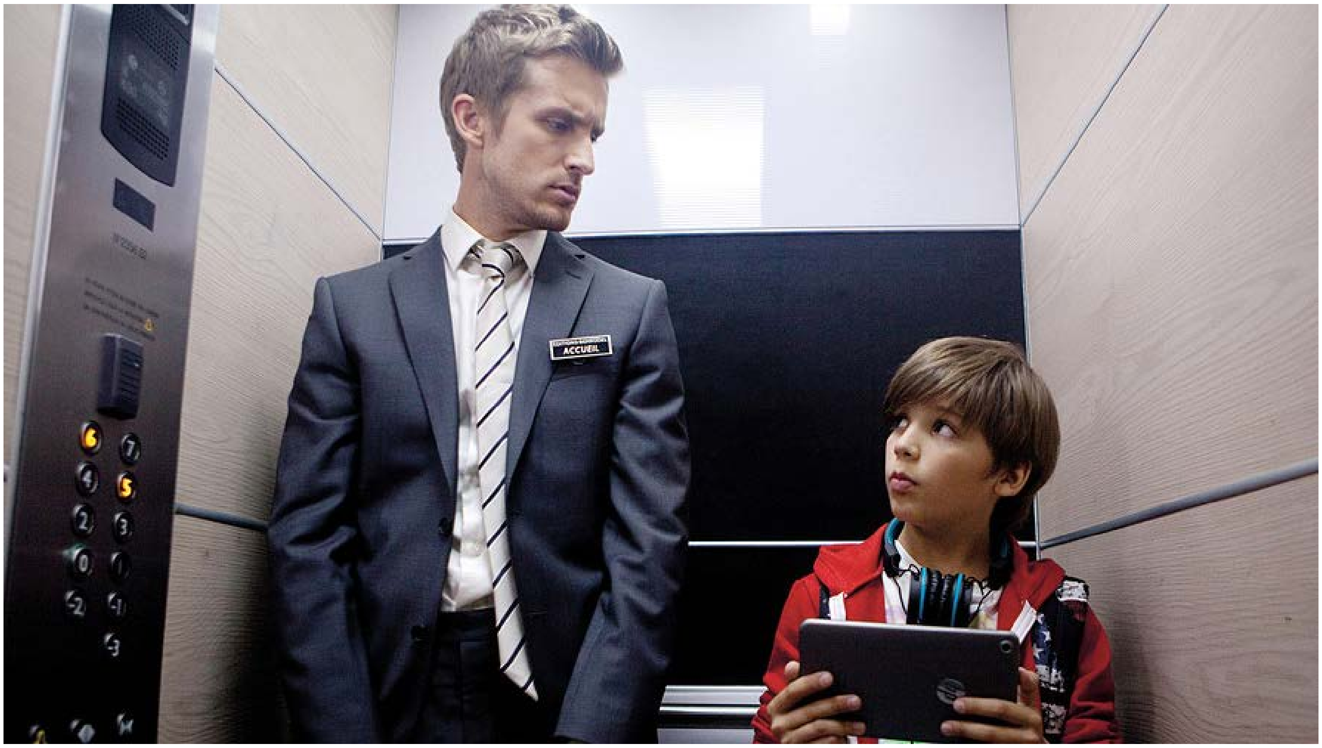
’Kids’ up to age 24 can be affected



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For 2018-2025, the Tax Cuts and Jobs Act (TCJA) revamps the Kiddie Tax rules to tax a portion of an affected child’s or young adult’s unearned income at the rates paid by trusts and estates. Those rates can be as high as 37% or as high as 20% for long-term capital gains and dividends. Before the TCJA, the Kiddie Tax rate equalled the parent’s marginal rate (which for 2017 could be as high as 39.6% or 20% for long-term capital gains and dividends).

The TCJA only changes the Kiddie Tax rate structure. The rest of the Kiddie Tax rules are the same as before. Here’s what you need to know about how the Kiddie Tax can come into play and how much it can cost under the current rules.

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Key Point: Unearned income for purposes of the Kiddie Tax means income other than wages, salaries, professional fees, and other amounts received as compensation for personal services. So among other things, unearned income includes capital gains, dividends, and interest. Earned income from a job or self-employment is never subject to the Kiddie Tax.

Kiddie Tax basics

Under the Kiddie Tax rules for 2018-2025, a portion of a child’s (or young adult’s) net unearned income can be taxed at the federal income tax rates paid by trusts and estates. This is unfavorable, because the trust and estate rate brackets are compressed compared to the brackets for a single individual. So the Kiddie tax hit on a child with substantial unearned income can be significant.

In calculating the federal income tax bill for a dependent child (or young adult) who is subject to the Kiddie Tax, the child is allowed to subtract his or her standard deduction amount. The allowable standard deduction for 2018 is the greater of: (1) $1,050 or (2) earned income + $350, not to exceed $12,000.

Age is key factor in measuring potential exposure to kiddie tax

The Kiddie Tax can potentially apply until the year during which a child (or young adult) turns age 24. For someone who is age 19-23 at year-end, the Kiddie Tax can only apply if he or she is a student. But a child who is age 18 or under at year-end is almost always exposed to the Kiddie Tax. More specifically, the Kiddie Tax applies when all four of the following requirements are met for the year in question:

Requirement 1: The child does not file a joint return.

Requirement 2: One or both of the child’s parents are alive at year-end.

Requirement 3: The child’s net unearned income exceeds the threshold for that year, and the child has positive taxable income after subtracting any applicable deductions, such as the standard deduction. The unearned income threshold for 2018 is $2,100. If the unearned income threshold is not exceeded, the Kiddie Tax does not apply. If the threshold is exceeded, only unearned income in excess of the threshold is hit with the Kiddie Tax.

Requirement 4: The child (or young adult) falls under one of the following three age-related rules due to his or her age at year-end and the other factors mentioned below:

Age Rule 1 (Age 17 or Younger): If the child is 17 or younger at year-end, the Kiddie Tax applies if the other three requirements are also met.

Age Rule 2 (Age 18): If the child is 18 at year-end, and does not have earned income that exceeds half of his or her support, the Kiddie Tax applies if the other three requirements are also met. Support does not include amounts received as scholarships.

Age Rule 3 (Age 19–23 and Student): If the child is age 19–23 at year-end and (1) is a student and (2) does not have earned income that exceeds half of his or her support, the Kiddie Tax applies if other three requirements are also met. The child is considered to be a student if he or she attends school full-time for at least five months during the year. Support does not include amounts received as scholarships.

Example 1: Angie will be 17 on 12/31/18. She falls under Age Rule 1. For 2018, she is subject to the Kiddie Tax if the other three requirements are also met.

Example 2: Biff will be 21 on 12/31/18. He graduated from college in May of 2018 but is determined to remain unemployed for the rest of this year. He is subject to the Kiddie Tax for 2018 under Age Rule 3, because he was a full-time student for the first five months of the year and will have very little earned income, if any, for the year. Nice going Biff!

Calculating the Kiddie Tax

First add up the child’s net earned income and net unearned income. Then subtract the child’s standard deduction to arrive at taxable income. The portion of taxable income that consists of net earned income is taxed at the regular rates for a single taxpayer. The portion of taxable income that consists of net unearned income and that exceeds the unearned income threshold ($2,100 for 2018) is subject to the Kiddie Tax and is taxed at the rates that apply to trusts and estates.

2018 Trust and Estate Rates for Ordinary Income (Income Other Than LTCGs and Qualified Dividends)

10% tax bracket $0-2,550

Beginning of 24% bracket $2,551

Beginning of 35% bracket $9,151

Beginning of 37% bracket $12,501

2018 Trust and Estate Rates for LTCGs and Dividends

0% tax bracket $0-2,600

Beginning of 15% bracket $2,601

Beginning of 20% bracket $12,701

Example 3: Child with both earned and unearned income owes Kiddie Tax.

For 2018, Gina (age 17) has $2,000 of earned income and $7,000 of unearned ordinary income from short-term capital gains and interest. Her standard deduction is $2,350 (based on her $2,000 of earned income + $350).

Gina’s taxable income is $6,650 ($2,000 + $7,000 − $2,350 standard deduction).

Of the $6,650 of taxable income, $4,900 ($7,000 unearned income - $2,100 unearned income threshold) is taxed at the trust and estate tax rates under the Kiddie Tax rules.

* The first $2,550 is taxed at 10%, resulting in $255 of tax.

* The next $2,350 ($4,900 - $2,550) is taxed at 24%, resulting in $564 of tax.

The last $1,750 of Gina’s taxable income ($6,650 - $4,900) is taxed at the 10% regular rate for a single taxpayer, resulting in $175 of tax.

So Gina’s federal income tax bill totals $994 (Kiddie Tax of $255 + $564 + regular tax of $175).

Key Point: Without the Kiddie Tax, all of Gina’s $6,650 of taxable income would have been taxed at 10% under the regular rates for single taxpayers, resulting in only $665 of tax.

The bottom line

Thanks to the TCJA, the Kiddie Tax is a bit easier to calculate than before, but it can be more expensive for a child or young adult with significant unearned income. If you have a child who is getting hit with the Kiddie Tax, a tax pro can identify strategies that will reduce the Kiddie Tax hit for 2018 and beyond.