Tax Cuts and Jobs Act

New Kiddie Tax Rules Could Result in Big Changes

by Tina A. Myers, CFP,® CPA/PFS, MTax, AEP,® Senior Financial Planner, Key Private Bank

Previously, the Kiddie Tax applied to the unearned income of a child that exceeded an inflation-adjusted amount ($2,100 in 2017). The Kiddie Tax applied to children under the age of 19 or dependent children who were full-time students ages 19-24 and was imposed using the parents' marginal tax rate, if that tax was higher than what the child would have otherwise paid. Unearned income generally included all income except wages, salaries, self-employed earnings, and other amounts received as compensation for personal services rendered. Examples of unearned income include capital gains, dividends, interest, and inherited individual retirement account (IRA) distributions (not an exhaustive list). For 2017, a child with no earned income would not be taxed on the first $1,050 of unearned income (which was the standard deduction for a child claimed as a dependent on another return); the next $1,050 would be taxed at the child's rate — then any unearned income above $2,100 was taxed at the parents' marginal tax rate.

The Kiddie Tax was put in place to counteract a variety of family income-shifting techniques that took advantage of the lower tax rates of the taxpayer's children by, in effect, taxing the family unit as a whole.

Under the old rules, calculating the tax on the child's excess unearned income was not as simple as just multiplying the income by the parents' marginal rate. Instead, the parents' tax was computed with and without the child's excess unearned income, with the difference being the tax on such amount. In some situations, this approach caused the parents' tax computation to cross over into a higher tax bracket, resulting in a higher marginal rate on some or all of the child's excess unearned income.

In 2017, when the Kiddie Tax applied to a child, it may have looked a little like this:

The child's income was taxed at the **10% ordinary rate (since that rate applied to the first $9,325),** or if the child's income included long-term capital gains or qualified dividends, the applicable capital gains rate was used

If there were multiple children in the family subject to the kiddie tax and each of them had **more than $2,100 of unearned income** (for 2017), the tax for all of the children was computed by reference to the parents' income and marginal tax bracket.

Each child's result was dependent on the taxable income of the other children and the parent. Because the tax was computed using the parents' marginal tax rate, the Kiddie Tax could not be computed accurately until the parent's income was known. Sometimes, the child's return had to be extended until the parents' return was completed.

The 2017 Tax Cuts and Jobs Act (2017 TCJA) modified the Kiddie Tax to effectively apply the estates' and trusts' ordinary and capital gains rates to the net unearned income of a child. The tax rates for trusts and estates increase much more quickly than those applying to individuals.

In 2018 for example, a married couple pays the top 37% marginal income tax rate when their taxable income exceeds $600,000. However, for estates and trusts, the top 37% rate kicks in when income exceeds $12,500, which is a much lower threshold.

Estates and Trusts Income Tax Rates	
Taxable Years Beginning in 2018	
If Taxable Income Is:	**The Tax Is:**
Not over $2,550	10% of taxable income
Over $2,550 but not over $9,150	$255 plus 24% of the excess over $2,550
Over $9,150 but not over $12,500	$1,839 plus 35% of the excess over $9,150
Over $12,500	**$3,011.50 plus 37% of the excess over $12,500**

Under the 2017 TCJA changes, the rules below apply in lieu of the above described Kiddie Tax computations.

- The maximum amount of taxable income taxed at rates below 24% can not exceed the child's earned taxable income + (for 2018) $2,550 (the minimum taxable income for the 24% bracket in the Estate and Trust Income Tax Table).
- The maximum amount of taxable income taxed at rates below 35% can not exceed the child's earned taxable income + (for 2018) $9,150 (the minimum taxable about for the 35% bracket in the Estate and Trust Income Tax Table).
- The maximum taxable income taxed at a rate below 37% can not exceed the child's earned taxable income + (for 2018) $12,500 (the minimum taxable amount for the 37% bracket in the Estate and Trust Income Tax Table.

For purposes of applying the capital gains tax rates:

- The maximum amount of capital gains taxed at a zero rate can not exceed the child's earned taxable income + (for 2018) $2,600.
- The maximum amount of capital gains taxed at a 15% rate can not exceed the child's earned taxable income + (for 2018) $12,700.

Overall, the new rules should simplify the tax calculation for many families. Now, the same rates apply to all children, instead of having varying rates based upon the parents' income. Also, the child's tax will no longer be affected by the unearned income of any siblings.

The TCJA does not change the definition of a child subject to the Kiddie Tax for purposes of the above-described modified Kiddie Tax rules in effect for 2018–2025. Unless Congress changes the applicable law, these changes do not apply for tax years beginning after December 31, 2025.

What do these changes mean for you?

At first blush, it may appear that because of the compressed tax brackets that top out at $12,500 that you will have bigger tax bills than in the past. However, that is not necessarily the case. For parents in higher tax brackets, the change may actually benefit the kids. This change could also end up costing the kids more. However, this situation may be more unlikely though. A child would have to have substantial unearned income with parents in a lower tax bracket than the child.

Unearned income (above $2,100) that may have been previously taxed at 39.6% or could potentially only be taxed at 10% for the first $2,550, and 24% if between $2,550 and $9,150, or if the unearned income qualifies for preferential tax rates 0% or 15% instead of the parent's 23.8% rate. That's a huge difference.

Parents should always be aware of the impact of realizing large gains in children's accounts. Selling assets in a child's portfolio to help finance college costs could mean the Kiddie Tax applies. Consider starting the sell-down process sooner to help manage gains and reduce the Kiddie Tax. Be sure to position yourself financially to take advantage of the 0% or 10% tax rate. Or consider gifting appreciated securities to students first and then having them sell the securities and utilize the capacity of their 0% and 10% rate as opposed to the parents' higher capital gains rate (which could be as high as 23.8%). Strategizing now could result in potential tax savings.

For more information about how these wealth planning strategies might benefit your particular situation, contact your Key Private Bank Advisor.

About the Author

As a senior financial planner with Key Private Bank, Tina Myers offers her clients sophisticated financial planning advice and a comprehensive set of strategies to grow and preserve their wealth. She collaborates with her team's Relationship and Portfolio Managers, coordinates strategies with attorneys and accountants, and follows up on a regular basis to ensure the plan is performing optimally.