CLIENT REPORT:
Income Tax Planning - The Kiddie Tax

Dear Client:

In recent years, Congress has made many changes to the so-called "Kiddie tax." Effective for 2009 and later years, the "Kiddie tax" applies to the unearned income of children who are under 19 (under 24 if a student). When a qualified child has unearned income in excess of a certain amount and does not file a joint return, the Kiddie tax may be applied to that income at the parents' tax rate instead of the child's tax rate.

Congress created the Kiddie tax to prevent abuses. It is designed to lessen the effectiveness of intra-family transfers of income-producing property, which shift income produced from such property from the parents' high marginal tax rate to the child's generally lower tax bracket, thereby reducing a family's overall income tax liability.

The Kiddie tax applies when one of the child's parents is alive at the close of the tax year; the child does not file a joint return for the tax year, and the child is in one of three categories. The categories are: (1) the child has not attained the age of 18 by the close of the tax year; (2) the child has not attained the age of 19 by the close of the tax year, and the child's earned income is less than one-half of the child's support for the year; or (3) the child is a student who has not attained the age of 24 by the close of the tax year, and the child's earned income is less than one-half of the child's support for the year. The Kiddie tax rules do not apply to a child who is married. Generally, the parent whose taxable income is taken into account is the custodial parent if the parents are divorced or otherwise not married; if the parents are married but are filing separate returns, the return of the parent with the greater taxable income must be used.

Let's take a look at an example. Harry is 13 years old and his father is alive. In 2009, he has $3,000 in unearned income, no earned income, and no itemized deductions. Harry's basic standard deduction is $950, which is applied against his unearned income, reducing it to $2,050. The next $950 of unearned income is taxed at Harry's individual tax rate. The remaining amount of his unearned income is subject to the Kiddie tax and is taxed at his father's rate. The age cap on the Kiddie tax allows you to plan in several ways. You may want to set up a gift-giving program. You may also want to wait to transfer property that will produce the most income only starting after the year in which the child reaches 19 (or 24). An investment in raw land with appreciation potential is one example. Some parents buy Series EE bonds for the child and have the child elect to defer tax on the interest as it accrues. Another idea is to buy cash-value life insurance. Inside build-up from the policy generally will accumulate tax-free.

You will also need to take into account any alternative minimum tax (AMT) liability. The source of the unearned income also is an important factor. One more thing: do not forget that the Kiddie tax applies only to unearned income. If you run your own business, you may get some modest savings if your child can legitimately be hired to work in the business.

Of course, careful planning and attention to detail are necessary, not only to achieve the intended tax consequences but also to ensure that any action fits in with your overall financial and family goals. Please do not hesitate to call if you would like to explore in greater detail the changes to the Kiddie tax rules and any of these or other tax-saving ideas.

Reproduced with permission from CCH’s Client Letter, published and copyrighted by CCH Incorporated, 2700 Lake Cook Road, Riverwoods, IL 60015.