



Kiddie Tax Rules

In May 2006, Congress enacted a law change that significantly expands the reach of the Kiddie Tax. As many are aware, the Kiddie Tax imposes the parents' top tax rate on the investment income of a child under age 14. The law change will expand the reach of the Kiddie Tax to children who have not attained the age of 18 before the close of the tax year, effective with the 2006 tax year.

There is a small exemption that continues to apply to the Kiddie Tax. For 2006, the first \$850 of an under age 18 child's earned income is tax-free, and the next \$850 is taxed at the child's marginal rate (generally 10%). But, unearned income exceeding \$1,700 is taxed at the parents' highest income tax rate, assuming the child is not age 18 by the end of the year. Fortunately, the Kiddie Tax only applies to unearned income such as interest, dividends, rents and capital gains. It does not apply to the wages or other income earned by the child, such as by baby sitting, lawn mowing, or paper delivery.

Implications of This Law Change

Tax Cost. For those families whose teenagers have accumulated some investments, the implications of this law change could lead to a surprising tax cost. For example, assume that a teen, through gifts and personal savings, has accumulated investments that produce \$3,700 of interest income for 2006. The child's exemption and personal rates only apply to the first \$1,700 of this income, leaving \$2,000 to be taxed at the parents' rate. The child's rate on this income would typically be 10%, while the parents' rate would typically range from 28% to 35%. Assuming the parents are at a 33% federal rate versus their child's 10% rate, the Kiddie Tax will cause a 23% additional tax on the \$2,000 of income, for a tax cost of \$460.

If the child's investment income consists of dividends or long-term capital gains, the tax increase is less severe. Typically, the child is taxed at a 5% rate on dividends and capital gains, whereas the parents are taxed at 15%. Accordingly, an extra 10% tax occurs on this type of unearned income exceeding \$1,700.

Investment Strategies. In some cases, the implications of the Kiddie Tax could be significant enough to cause a repositioning of the under-age-18 child's investments. Rather than incur the parents' high tax rate on investment earnings, it may make sense to shift the child's investments to growth equities that pay little or no dividends. Tax-exempt municipal bonds or tax-sheltered savings vehicles such as IRAs, qualified tuition/Section 529 plans and the like may also make sense.

It is also important to be aware of the Kiddie Tax before selling a child's capital gain investments. A mutual fund or stock the child has held for ten years might produce a significant capital gain upon sale. If sold at age 16, the parent capital gain rate of 15% applies. But, if sold at age 18 when free of the Kiddie Tax, the child's lower 5% capital gain rate applies, at least to the extent of about the first \$30,000 of gain.

Tax Preparation Complexity. One of the more unfortunate aspects of this Kiddie Tax law change is the added tax return preparation hassle. If a child under age 18 has over \$1,700 of investment income, that child's tax return needs to be carefully coordinated with the parents' return. In some cases, the child's investment income can be reported on the parent's return. Otherwise, a complicated schedule must be added to the child's return that integrates both the parents' and child's income to arrive at the proper Kiddie Tax. This means that the child's return can no longer be done separately and filed early.

If we prepare both your return and your teenager's return, we will of course coordinate this and no special action is needed on your part. If you are preparing your teenager's tax return, it will be very important to determine if the Kiddie Tax may apply. If the child's return is filed without properly considering the Kiddie Tax, it can be a very time consuming and expensive to correct the situation. If there is any doubt as to whether the Kiddie Tax threshold has been tripped, we strongly recommend you allow us to check the child's data at the time we meet for the preparation of your Form 1040.

Please let us know if there are any questions regarding these matters.