Taxing the Income of Children

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Parents often forget—or don't realize—that the income their child earns from babysitting, mowing lawns, doing odd jobs, etc., is taxable. Indeed, children with income of their own, from whatever source (earned and unearned), are subject to income tax just as any other taxpayer, and children with substantial unearned income may be subject to the additional provisions of the kiddie tax.

In general, for the tax year 2006, a dependent child must file an income tax return if that child has:

- earned income over $5,150;
- unearned income of $850 or more; or
- earned and unearned income totaling more than the lesser of
  - $5,150 or
  - the larger of $850 or earned income plus $300.

If a dependent child has gross income less than $850, no income tax return is required to be filed (IRC §6012(a)(1)).

For example, Gillian lives at home with her parents and celebrated her 17th birthday during the year. Gillian has $2,000 of unearned income and no earned income this year. Gillian's parents will claim her as a dependent and are in the 33% tax bracket. Gillian will file a separate tax return showing taxable income of $1,150 ($2,000 – $850 standard deduction) and a tax liability of $115 ($1,150 × 10%). Because Gillian's parents claim her as a dependent, she isn't allowed a personal exemption on her own tax return.

In addition to the general rule, IRC §1(g) provides a special tax (the kiddie tax) for a child with substantial unearned income whether or not the child is claimed as a dependent by a parent as long as one of the parents is alive. Prior to the enactment of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), the kiddie tax was imposed if:

- the child hadn't reached the age of 14 by the end of the tax year;
- the child's unearned income was in excess of the inflation adjusted threshold amount ($1,700 in 2006); and
- the child was required to file a return for the year.

In calculating the tax liability, the child's income is separated into two pieces: The first piece, net unearned income, is the child's unearned income in excess of the threshold amount. If the parents' marginal tax rate is higher than the child's, the child's net unearned income is taxed at the parents' marginal rate. Otherwise, it is taxed at the child's marginal rate.

The second piece is the remainder of the child's taxable income, i.e., earned income plus unearned income over the threshold amount

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minus the child's standard deduction. This is taxed at the child's marginal rate. For example, Joey lives with his parents and celebrated his 13th birthday during the year. He has \$4,000 of unearned income and \$6,000 of earned income for the current year. Joey's parents are in the 33% tax bracket and will claim Joey as a dependent. Joey's net unearned income is \$2,300 (\$4,000 – \$1,700). His taxable income is \$4,850 (\$6,000 + \$4,000 – \$5,150). Note that the standard deduction amount for a single taxpayer in 2006 is \$5,150. Joey's marginal tax rate is 10%, so his net unearned income is taxed at his parents' marginal rate. The tax is \$759 (\$2,300 × 0.33). The remainder of his taxable income, \$2,550 (\$4,850 – \$2,300), is taxed at Joey's marginal rate. It amounts to \$255 (\$2,550 × 0.10). Thus, Joey's total tax liability is \$1,014 (\$759 + \$255).

Since its inception in 1986, few changes had been made to the kiddie tax until TIPRA was signed into law on May 17, 2006. It made three changes to the kiddie tax. The first change is significant because it is retroactive for 2006. Beginning with tax year 2006, IRC §1(g)(2) now applies to children under 18 (instead of 14) at the end of the tax year. Under the new law, Gillian, who is 17 and has unearned income of \$2,000, is subject to the kiddie tax. Her net unearned income of \$300 (\$2,000 – \$1,700) is taxed at her parents' marginal tax rate of 33%, and her portion of the unearned income of \$850 (\$2,000 – \$850 – \$300) is taxed at her marginal rate of 10%. Gillian's tax liability is \$175 ((\$300 × 0.30) + (\$850 × 0.10)). The impact of TIPRA on Gillian, therefore, is an additional tax liability of \$60 (\$175 – \$115).

The second change is that the kiddie tax doesn't apply to a taxpayer's child if the child files a joint return. As the law is written, it would appear that a child who is under 18 and is eligible to file a joint return but elects to file a separate return for whatever reason would be subject to the kiddie tax rules.

Third, net unearned income doesn't include distributions from qualified disability trusts. That is, any amount included in the income of a child as a beneficiary of a qualified disability trust (described in IRC §642(b)(2)(C)(ii)) will be considered earned income for that child, whether the distributions are from current income or corpus (IRC §652 and §662).

There are a number of subtle issues associated with the tax on minors. For example, provisions that apply to other taxpayers also apply to children subject to the kiddie tax. If a child has earned income and elects to invest those earnings, the resultant investment income is unearned income. Also, if a child is blind and, therefore, eligible for the additional standard deduction, that additional amount increases the standard deduction amounts in calculating the kiddie tax.

There are other interesting aspects to the kiddie tax. In the case of unmarried parents or those married but filing separately, things get a bit murky. IRC §1(g)(5)(A) holds that if the parents aren't married, it is the taxable income of the custodial parent that is used to determine the tax rate applied to the child's net unearned income. If the parents file separately, it's the income of the parent with the highest taxable income that is used. But what if the parents were never married? The answer to this question is found on page 6 of *IRS Publication 929*. If the parents lived together all year, the income of the parent with the highest taxable income is used. If the parents didn't live together all year, the income of the parent with the most custodial time is used.

An even darker issue is the Alternative Minimum Tax (AMT), which applies to all taxpayers and has specialized rules for the income of minor children. When applied to the income of a minor child (IRC §59(j)(1)), the AMT exemption amount is limited to the lesser of:

- earned income plus \$6,050 (for 2006) or
- the exemption amount for an unmarried taxpayer (\$42,500 for 2006).

For example, Tina celebrates her 16th birthday in 2006. She has unearned income of \$3,500 and earned income of \$6,750. The AMT exemption amount for Tina is \$12,800, which is the sum of her earned income of \$6,750 and the statutory amount of \$6,050. This is less than the maximum exemption amount of \$45,000.

All citizens and residents of the United States are subject to the federal income tax laws. Being very young provides no exception. Although the assets of a child are the source for the payment of any income tax to which a child may be subject, parents have the responsibility to make sure the proper tax return is filed and any taxes due are paid. ■

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