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Expansion of the Kiddie Tax

BY WILLIAM B. POLLARD

The kiddie tax was created by The Tax Reform Act of 1986 (P.L. 99-514). Initially it applied to children under the age of 14, causing their net unearned income to be taxed at the same rate as their parents' income. The Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-122) raised the age cutoff, making children under 18 subject to the tax. Now The Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28) has extended the kiddie tax's reach again. Starting in 2008, it not only applies to children under 18, but also to children age 18 who have earned income equal to or less than one-half their support and to children ages 19 through 23 who are full-time students and have earned income equal to or less than one-half their support. Table 1 demonstrates how the kiddie tax applies to one theoretical family, showing the relevant kiddie tax information for Jay and Kay Taxpayer, who have 10 children, including 18-year-old quadruplets.

The age of the child is determined based on his or her age on the last day of the year. Under a common law rule, however, an individual reaches a given age on the day before that person's birthday. Therefore, a child born on January 1, 1991, is considered to be 18 at the end of 2008.

Increasing the Age Range

The kiddie tax imposed by IRC §1(g) is designed to prevent parents from shifting unearned income from themselves to their child or children in an effort to benefit from the child being in a lower tax bracket. For example, in addition to the lower tax rates available to lower income individuals already in place, the tax rate on capital gains in 2008 for persons in the lowest tax brackets falls to 0%. Expanding the age range of the kiddie tax eliminates the opportunity for families to switch capital gains to children in lower tax brackets in order to avoid the 15% capital gains rate the parents are subject to due to being in a higher bracket.

Unearned income (also called investment income) includes items such as taxable interest, ordinary dividends, capital gains, royalties and rents (as well as less familiar items such as taxable social security benefits, annuity and pension income and unearned income received as the beneficiary of a trust). To arrive at net unearned income for 2008, subtract $900 ($850 in 2007) from gross unearned income, as allowed by IRC§1(g)(4)(A)(ii)(I) (Rev. Proc. 2007-66, 2007-45 IRB 990). (See IRC §1(g)(4)(A)(ii)(II) for special rules if deductions are itemized.) An additional $900 ($850 in 2007) is available as a standard deduction for a dependent with only unearned income for 2008. Accordingly, the following rules apply to determine if a child might be subject to the kiddie tax for 2008:

1. The child had more than $1,800 of unearned or investment income,

2. At least one of the child's parents is alive at the end of 2008,

3. The child doesn't file a joint return for 2008, and

4. The child is under age 18, aged 18 with earned income equal to or less than one-half his or her support, or aged 19-23 and a full-time student

Table 1. Applying the Kiddie Tax

Name	Age	Is the child a full-time student?	Does the child have earned income equal to or less than one-half his or her support?	Is the child subject to the kiddie tax?
Ana	15	Yes	Yes	Yes
Brad	16	Yes	No	Yes
Charlie	18	Yes	Yes	Yes
Dwayne	18	Yes	No	No
Elise	18	No	Yes	Yes
Frank	18	No	No	No
Gwyn	20	Yes	Yes	Yes
Hank	21	Yes	No	No
Ivan	22	No	Yes	No
Juan	23	No	No	No

with earned income equal to or less than one-half his or her support.

The Economic Stimulus Provisions

There are two options once it has been determined that the kiddie tax is due. The first option is for a parent to file Form 8814, "Parent's Election to Report Child's Interest and Dividends." The IRS cautions parents at the beginning of Form 8814 that the federal income tax on the child's income may be less if they instead choose to file a separate tax return for the child and not file Form 8814. The second option, as suggested by the IRS, is to file a separate return for the child and attach Form 8615. (Formerly titled "Tax for Children Under Age 18 With Investment Income of More Than $1,700," this will need to change in 2008 to reflect the new age range and allowance.)

One factor to consider in determining which way to file the kiddie tax information is whether a child qualifies for an economic stimulus payment under the provisions of The Economic Stimulus Act of 2008 (P.L. 110-185). Since the payment won't be made to anyone who can be claimed as a dependent on someone else's tax return, many children subject to the kiddie tax don't qualify to receive an economic stimulus payment. If a child does qualify, however, the eligible child must file an income tax return for 2007. Also keep in mind that the 2008 economic stimulus payment is technically an advance rebate (or refund) check paid in 2007 (based on 2007 tax information) as a credit against the tax for the 2008 tax year. (If hindsight based on actual 2008 data shows a smaller check was warranted, the taxpayer won't have to pay back the difference.) But if someone was unable to claim a refund (or a full refund) in 2007, the person may be able to claim the credit on the 2008 tax year return (see "Stimulus Payments: Answers to Frequently Asked Questions" on the IRS website at www.irs.gov/newsroom/article/0,,id=179181,00.html).

The AMT Provisions

A child subject to the kiddie tax may also be subject to the alternative minimum tax (AMT). Rev. Proc. 2007-66, 2007-45 IRB 990 increased the exemption amount in IRC §55 and §59(j) for a child subject to the kiddie tax to a minimum exemption amount of $6,400 for 2008 ($6,300 in 2007). Also exempt from the AMT is earned income for a child up to the personal credit amount ($44,350 in 2007) less the minimum exemption. Therefore, for 2007, a child could have earned income of $38,050 ($44,350 - $6,300) without being subject to the AMT. What about 2008? Unfortunately, the personal credit amounts imbedded in the AMT are not inflation-adjusted numbers, which has caused the recurring annual headaches with the AMT. In October 2007, Congress notified the IRS of the intent to increase the personal credit amount for 2007 (to $44,350 for singles and heads of households, $66,250 for married filing jointly or qualified widow(er)s, and $33,125 for married filing separately). Unfortunately, The Tax Increase Prevention Act of 2007 (P.L. 110-66) didn't pass Congress until December 19, 2007, and only provides a temporary "patch" for AMT relief for 2007. Accordingly, the AMT dilemma continues, with anticipation for a solution (or at least another "patch") by the end of the current year. If no additional relief is provided, the amounts currently scheduled to be in effect for 2008 will revert to older, lower numbers ($33,750 for singles and heads of households, $45,000 for married filing jointly or qualified widow(er)s, and $22,500 for married filing separately).

Proper Planning

American statesman Benjamin Franklin noted, "Nothing can be said to be certain except death and taxes." American humorist Will Rogers added, "The difference between death and taxes is: Death doesn't get worse every time Congress meets." So it may seem with the kiddie tax. As children get older and go to college, so does the kiddie tax. By planning accordingly, however, unwanted consequences of this newly expanded tax can be avoided. ■

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