Impact of Tax Reform on the Kiddie Tax and Transfers to Minors

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By now, we all know that major tax legislation was passed in December of 2017. The 2017 revenue act (the "2017 Tax Act") is officially titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," but it is more commonly referenced as the "Tax Cuts and Jobs Act."[1] The 2017 Tax Act effected many changes, albeit temporary, to the individual income tax, including a modification of the individual income tax rates set forth in § 1 of the Internal Revenue Code.[2] One aspect of the modified tax rates includes changes to the Kiddie Tax rules, which have not received as much attention as other provisions of the 2017 Tax Act.

What is the Kiddie Tax?

The "Kiddie Tax"[3] is an income tax imposed on the *net unearned income of a child* (or young adult) who has not attained the age of nineteen (19) prior to the end of the taxable year or, in the case of a full-time student,[4] has not attained the age of twenty-four (24) prior to the end of the taxable year.[5] For purposes of this article, the term "child" or "children" refers to both minors and young adults who may be subject to the Kiddie Tax. Prior to the 2017 Tax Act, a child's net unearned income was taxed at the parents' top marginal tax rates, if the parents' tax rates were higher than the child's individual tax rates. A child's earned income, on the other hand, is taxable at individual tax rates applicable to unmarried persons. Generally, "net unearned income" means the portion of the child's adjusted gross income (less minimal deductions) for the taxable year that is not attributable to wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered.[6] Unearned income includes items such as dividends, interest and capital gains.

The Kiddie Tax was first enacted as part of the Tax Reform Act of 1986 in an effort to deter wealthy parents from "shifting income-producing assets to their children, who were usually subject to lower tax rates."[7] Although the Kiddie Tax is imposed on all of a child's unearned income (as opposed to just unearned income attributable to property a child receives from his or her parents), its drafters have defended claims that the Kiddie Tax is overbroad by asserting that (1) most minor children's unearned income comes from their parents, (2) a blanket tax on all unearned income (and not just income stemming from parental transfers) is justifiable as a result "of the complexity and recordkeeping involved in distinguishing between different sources of unearned income," and (3) parents effectively control all property owned by their minor children, regardless of how the children acquired it.[8] Notably, the original Kiddie Tax rules applied only to minors under the age of fourteen (14). As previously mentioned, however, the current rules apply to both minors and young adults, which seemingly undermines many of the original drafters' assumptions regarding parental control.

How did the 2017 Tax Act change the Kiddie Tax?

While the 2017 Tax Act does not change the taxation of a child's earned income, beginning with the 2018 tax year, the net unearned income of a child subject to the Kiddie Tax rules will be taxed at the rates applicable to trusts and estates. This will not impact high-income earners who were already in the highest income tax bracket, but it will affect lower- and middle-income earners.[9]

The 2017 Tax Act has largely been touted as an act to reduce tax rates, but the application of tax rates for trusts and estates to the unearned income of children is more likely to result in a higher tax bill for children. While the compressed rate structure reduces some of the complexity of the Kiddie Tax,[10] and it certainly deters tax-motivated income shifting from parents to their children since any significant amount of income for a child will almost immediately be subject to income tax at the highest marginal rate, it continues to encourage spending and discourage saving and investment by reducing a child's after-tax return, even where the child earns income on savings or investments financed solely from the child's earnings (and let's not forget we are potentially talking about 23-year-old college students).

The potential benefit of the compressed rate structure arises where the child's parents are in a high tax bracket and the child has an insubstantial amount of unearned income. As reflected by the tax brackets included below, however, trusts and estates reach the highest tax bracket, where the ordinary income tax rate is equal to thirty-seven percent (37%), after only $12,500 of income, which is far lower than the income threshold for an individual to reach the same bracket ($500,000).

Example 1: For example, suppose a child's net unearned income for 2018 is equal to $1,500 and the child's parents are in the 24% income tax bracket. In this case, the child's tax liability is lower under the 2017 Tax Act than under prior law. The child's 2018 tax liability attributable to his or her net unearned income would be $150 (10% of $1,500) (as opposed to the $360 tax liability (24% of $1,500) imposed under the law in effect prior to January 1, 2018, which taxed children at their parents' rates).

Example 2: Assume the same facts as Example 1 above, except that instead of $1,500 of net unearned income, the child has $13,000. In this case, the 2017 Tax Act's changes result in an increased tax bill for the child. In 2017, the child's tax liability would have been $3,120 (24% of $13,000). In 2018, the child's tax liability would be $3,196.50 ($3,011.50, plus 37% of $500).

How does the change to the Kiddie Tax impact planning for transfers to minors?

Advisors should inform affected clients of the potential advantages and disadvantages of the new tax brackets for the Kiddie Tax. Depending upon client goals, advisors may want to consider suggesting alternatives to the outright transfer[11] of income-producing property to children as a result of the new Kiddie Tax regime. For example, contributions to a tax-advantaged § 529 plan, employment of the child in a family-owned business, or the transfer of non-income-producing property[12] may better accomplish the client's objectives, while also avoiding the Kiddie Tax.

2018 Tax Brackets and Rates on Ordinary Income[13]

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

2018 Tax Brackets on Capital Gains and Qualified Dividends[14]

If taxable income is:	The capital gains tax rate is:
Not over $2,600	0%

$2,601 to $12,700	15%
$12,701 and over	20%

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[1] The tax bill was originally passed by the House of Representatives under the short title, "Tax Cuts and Jobs Act," however, Senate rules applicable to legislation being passed through the budget reconciliation process required that the short title be removed.

[2] These changes are currently scheduled to expire on December 31, 2025.

[3] One professor, who participated in drafting the Kiddie Tax, refers to this nickname as "the jocularly self-deprecating sobriquet" of the 1986 changes to the taxation of children. *See* Victor Thuronyi, The Kiddie Tax: A Reply to Professor Schmolka, 43 Tax L. Rev. 589, 589 (1988).

[4] "Student" has the meaning set forth in § 152 of the Code.

[5] I.R.C. § 1(g)(2). *See also* I.R.C. § 152(c)(3). The Kiddie Tax does not apply if the child has attained age eighteen (18) and earns more than fifty percent (50%) of his or her support. I.R.C. § 1(g)(2).

[6] I.R.C. § 1(g)(2). See also I.R.C. § 911(d)(2).

[7] Gerri B. Chanel, The Kiddie Tax: Inequitable Consequences and the Need for Reform (Jan. 31, 2015), available at https://www.thetaxadviser.com/issues/2015/feb/chanel-feb15.html.

[8] Thuronyi, supra note 3, at 590-591.

[9] Interestingly enough, a New York University law professor, Leo Schmolka, proposed the same change in his call for reform of the Kiddie Tax in 1987 (almost immediately after the Kiddie Tax was first enacted). *See* Leo L. Schmolka, The Kiddie Tax Under the Tax Reform Act of 1986: A Need for Reform While the Ink Is Still Wet, 11 REV. TAX'N INDIVIDUALS 99 (1987).

[10] For instance, the child's tax liability is no longer affected by the parents' tax situation. However, calculating a child's tax liability can still be confusing because the child is required to perform two calculations—one with respect to earned income and one with respect to unearned income.

[11] Transfers to children under the age of eighteen (18) should comply with the Uniform Transfer to Minors Act (which has been adopted in every state except South Carolina) unless a guardian is appointed by a court of competent jurisdiction to manage the child's property.

[12] The potential gift tax impact of any transfer should also be considered, but such analysis is outside the scope of this article.

[13] I.R.C. § 1(j)(2)(E).

[14] I.R.C. § 1(j)(4)(C), 1(j)(5).