Congress Changes ‘Kiddie’ Tax Rules for 2019 and Retroactively for 2018

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As part of the Tax Cuts and Jobs Act of 2017 (TCJA), Congress made a major change to the “kiddie” tax, the tax that many children/young adult dependents with investment income have been paying over 30 years. However, when Congress learned of the horrendous consequences of the modified “kiddie” tax rules, Congress reversed itself and repealed the changes.

Congress’ reversal has resulted in giving affected individuals important choices to make on their 20 federal income tax returns which they are currently preparing. In particular, they need to decide whether to use either the 2018 “kiddie” tax rules or the pre-TCJA “kiddie” tax rules in preparing 20 returns. They also need to decide whether to amend their 2018 federal tax returns if they filed the returns using the now repealed “kiddie” tax modified rules in effect when preparing 2018 tax retur

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History of the ‘Kiddie’ Tax

To understand how Congress’ modification to the “kiddie” tax rules in the TCJA had such a negative impact on many individuals, it is important to review the history of the “kiddie” tax and what Congr original motivation was in creating this tax.

As part of the tax overhaul in 1986, Congress passed into law the “kiddie” tax to discourage wealth individuals from giving income producing capital assets (stocks, bonds, mutual funds, etc.) in order their children to take advantage of the lower tax rates that children are subject to.

How the ‘Kiddie’ Tax Works

The “kiddie” tax works as follows: A child’s “unearned” income (this includes interest, dividends, capital gains, annuity benefits, and financial aid payments) above a small exemption being subject t federal income tax at the parents’ marginal tax rate. For 2019 and 2020, the exemption is $2,200. Note that the “kiddie” tax does not apply to a child’s “earned” income (salary or wages). This means that if a child had a job as a summer camp counselor last summer earning a total of $2,500, then the $2,500 is not subject to the “kiddie” tax. But if the child had additional investment income of $3,00

the $3,000 less exemption of $2,200, or $800, is subject to the “kiddie” tax.

During the period 1986 through 2017, the “kiddie” tax expanded. When it first became law in 1987 the “kiddie” tax affected children under the age of 14; then it was expanded to include children unc the age of 18 and finally expanded to include young people under age 24 if they are full-time studei and not self-supporting. According to the most recent IRS figures, individuals filed about 370,000 “kiddie” tax forms and paid $1.1 billion in taxes when filing 2017 tax returns.

Over the years completing IRS Form 8615 (Tax for Certain Children Who Have Unearned Income) form used to calculate the “kiddie” tax for children who have the minimum amount of unearned income] has been a challenge, especially for families with several children affected by the “kiddie” t or for families in which children’s parents are divorced. One particular challenging question involve whether the children should include their income on their parents’ tax returns instead of the childr filing their own return. Unbeknown to many parents and children, by filing their own tax return anc paying a tax on their unearned income, many children may have hurt their chances for financial aid from the college or university financial aid offices.

The purpose of the 2017 TCJA “kiddie” tax overhaul was to simplify the “kiddie” tax calculation. In particular, the major modification in the calculation of the “kiddie” tax was to tax a child’s unearnec income above a certain amount at *trust tax rates*, instead of at the parents’ *individual tax rate*. Whi the change streamlined the calculation, Congress overlooked the changes’ disastrous effects had o low- and middle-income families. Some of the children from these families had unearned income coming from survivor benefits, taxable financial aid, and from other sources that the families had n idea how this unearned income affected the children’s “kiddie” tax liability.

The Problem with The Change

The real problem with the change is that trust tax rates far exceed individual tax rates for the same amount of taxable income. For example, the top marginal tax rate of 37 percent kicks in at $13,000 taxable income generated in a trust. For married individuals filing jointly, the top marginal tax rate 37 percent for individual filing as married filing joint kicks in starting at $612,350 of taxable incom

One group widely affected by the new "kiddie" tax rules are families with children receiving militar survivor's benefits, often called "Gold-Star" families. There is the case of a widow of a Navy officer, who with her survivor military benefits, was in a federal marginal tax bracket of 12 percent in 2018 On the other hand, her 6-year old son, who received children military survivor benefits of $29,000 paid the maximum 37 percent tax on his survivor benefits as a result of the modified 2018 "kiddie" calculations, a direct result of the TCJA "kiddie" tax modification.

Repealing the "Kiddie' Tax Revisions

Late in 2019, Congress responded by repealing the 2017 "kiddie" tax revision and restated the pre-2018 "kiddie" tax rules, effective Jan. 1, 2020. In addition, Congress allowed affected filers to choose either version of the "kiddie" tax calculation for tax years 2018 and 2019. If a family paid th "kiddie" tax on their 2018 federal tax returns, they are encouraged to review their returns using th pre-2017 "kiddie" tax calculation rules. In so doing, if the family will most likely end up paying fewe taxes using the pre-2018 "kiddie" tax rules. They will then need to amend their 2018 federal incom tax returns using Form 1040X, and perhaps amend their 2018 state income returns if their 2018 st income tax liabilities may have been affected by the law change.

With the "kiddie" tax revision, the increase of the estate/gift tax exemption, the lowering of individ tax rates resulting from TCJA (at least through the year 2025), and the preferential tax rates that apply to long-term capital gains (a zero percent tax on long-term capital gains for individuals in the and 12 percent federal marginal tax brackets), there are opportunities for family members to give t efficient gifts to other family members.

The following examples illustrate:

Example 1. *Delores, age 25, intends to enroll in professional barber school. Her parents gift her $45,000 of ABC stock shares that the parents bought 20 years ago for $20,000. Delores, who has*

other income, immediately sells the stock and incurs a long-term capital gain of $45,000 less $20,0 or $25,000.

Delores is not subject to the "kiddie" tax because she is over age 24. Since Delores has no other income, her total 2020 income after selling the stock shares in $25,000. This puts Delores in a 10 percent tax bracket, resulting in her paying a zero income tax paid on the $25,000 net long term capital gain. Also, Delores' parents owe no federal gift tax because each parent gets a $15,000 exemption for their daughter's stock gift and the remaining $15,000 can be deducted from the parents' combined lifetime gift exemption of $23.16 million.

Example 2. *During 2018, Benjamin, age 20 and a college student, received $25,000 of financial aid that was considered taxable income to Benjamin. The $25,000 was considered "unearned income" Benjamin and taxed at the maximum "kiddie" tax rate of 37 percent rather than at Benjamin's pare federal marginal tax rate of 22 percent. With the recent law change in calculation of the "kiddie" ta the $25,000 of financial aid should be taxed at the parent's 22 percent marginal tax rate, resulting savings of (0.37 less 0.22) or .15 times $25,000, or $3,750, in federal income taxes to Benjamin. Benjamin needs to amend his 2018 federal income tax return, requesting a refund of $3,750.*

Example 3. *A grandparent gifts her 7-year old granddaughter ABC stock worth $15,000. The stock has a 4 percent dividend yield, and was originally acquired for $3,000. Since the granddaughter has other income, the granddaughter pays no income tax on the 4 percent of $15,000, or $600, in annu dividends. If the granddaughter were to sell the stock, the cost basis of the stock would be $3,000. There would be a long term capital gain of $15,000 less $3,000, or $12,000. "Kiddie" tax would be due, calculated using the granddaughter's parents' long-term capital tax rate of 15 or 20 percent (most probably 15 percent).*

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