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Radie Bunn

Craig Langstraat

Cherie J. O'Neil

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Minimizing The Kiddie Tax

By Radie Bunn and Craig Langstraat

Editor: Cherie J. O'Neil, Virginia Polytechnic Institute, Blacksburg, VA

The Tax Reform Act of 1986 (TRA '86) restricts the tax advantages of transfers of income-producing property from parents to children.[1] Under pre-1987 law, income-producing property owned by parents could be given to a child (or a trust for the benefit of a child) with the investment income from the property taxed at the child's lower tax rate. The TRA '86 altered this provision by requiring a child under age 14 with a living parent and unearned income over $1,000 to be taxed at the parent's top marginal rate.[2] The "kiddie tax" temporary regulations were issued to clarify the application of these new rules.[3] This article analyzes these new temporary regulations and discusses a shift of emphasis from income to estate planning as a strategy for providing the best opportunity to minimize the "kiddie tax."

5% Surtax Applied to Parent's Taxable Income Is Effected

The temporary regulations specify that the child's net unearned income is to be added to the parent's income to determine if the parent is subject to the phase-out of personal exemptions and the 15 percent rate bracket.[4]

Assume that in 1988 a married couple with one minor child has taxable income of $71,900. Their 12-year-old child has net unearned income of $3,000. The tax at the parent's 33 percent rate (28% + 5% surcharge) is $990. ($3,000 × 33%)

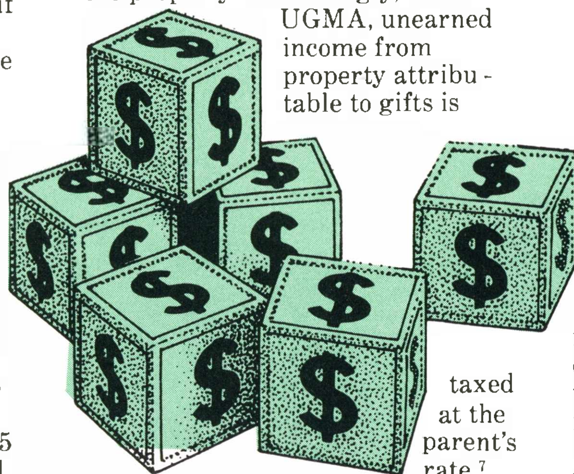
The additional 5 percent rate is applied to taxable income of up to $182,010 for this couple, which phases out the tax benefit of the 15 percent rate bracket and personal exemptions. However, the effect of limitations or floors on deductions or credits is not considered because the parent's adjusted gross income is not changed.[5]

Computation of Child's Marginal Rate

The parent's marginal rate applies to the unearned income of any child under age 14.[6]

Assume that in 1988 a 12-year-old child receives $1,500 of dividend income on corporate stock received as a gift from grandparents in 1985. The parents are in the 28 percent marginal tax bracket. The first $500 of the child's dividend income is not subject to tax due to the standard deduction. The second $500 is taxed at the child's rate (15% × $500 = $75). The excess over $1,000 is taxed at the parent's rate (28% × $500 = $140). The total tax due from the child is $215.

The dividend income on the above gift is taxed as if it were income received by the parents. Although a gift under the Uniform Gifts to Minors Act (UGMA) vests legal title to the property in the child, an adult custodian manages the property. Accordingly, under UGMA, unearned income from property attributable to gifts is



taxed at the parent's rate.[7] Other sources of unearned income such as taxable social security, pensions and investment earnings are taxed the same way.[8] Thus, for a minor child (under 14) who has no earned income, all **unearned** income in excess of $500 and the standard deduction of $500 will be taxed at the parent's rate regardless of the source of the assets creating the income.

Computation of Child's Standard Deduction

For a dependent child, the standard deduction is the greater of $500 or earned income limited to $3,000.[9] Only a portion of the child's first $1,000 of unearned income may be taxed.The first $500 is tax-free (due to the standard deduction), while the second $500 is taxed at the child's lower rate.[10]

Assume that in 1988, Betty, a 13-year-old child, receives $1,400 from a taxable pension and wages of $700. Betty reports $2,100 of gross income, less the standard deduction of $700. The $700 standard deduction amount is allocated $500 against unearned income and $200 against earned income. The taxable income of $1,400 will be taxed as follows: $1,000 is taxed at Betty's rates and $400 is taxed at Betty's parent's rates.

Trust Income

The Technical Corrections to the TRA '86 explain the computation of a child's tax where the parent's rates are used to determine the tax of a trust.[11] When the parent's marginal tax rates are used to calculate both the income tax of a trust under Sec. 644 and the income tax of their children under 14, the tax of the trust is calculated first independently of the income of the minor child. The tax of the minor child is determined by including the income of the trust in the income of the parent.

In addition, a child who is a trust beneficiary includes unearned trust income to the extent of distributable net income included in the child's gross income for the year.[12] There are no specific rules provided for accumulated distributions by a trust under Sec. 665(b). The general rule under Sec. 665(b) excludes income accumulated before age 21 from accumulation distributions for children under 14. The IRS will provide future guidance by information releases or revenue rulings for any situations outside the exception of Sec. 665(b).

Which Marginal Tax Rate?

If the parents are married but file separate returns, the child's tax is figured using the top tax rate of the parent who has the higher income.[13] If the parents are divorced, unmarried, or legally

separated, the rate used is the rate of the parent who has custody of the child for more than six months in the year.[14] If the custodial parent files a joint return with a nonparent spouse, their joint marginal tax rate is used to figure the child's tax.[15]

Tax Allocation and Recomputation

If there are other children under 14, the unearned income is combined and the increase in tax is allocated to the children based on their prorata portion of unearned income.[16] If the parent's taxable income is changed through audit or the filing of an amended return, or the net investment income of one or more of the parent's other children is adjusted, the child's tax must be recomputed using the adjusted amount.[17]

Unanswered Questions

While the new regulations provide guidance, some unanswered questions remain. The regulations do not discuss what rules to apply if either child or parent is subject to the alternative minimum tax. However, the Technical Corrections to the TRA '86 provide that the alternative minimum tax imposed on the net unearned minimum taxable income of a child under 14 will be at least what the alternative minimum tax would have been if the income were included in the parent's alternative minimum taxable income.[18] An illustration provided in the bill is as follows:

> A child's net unearned income is $10,000, and the unearned minimum taxable income is $20,000 which includes $10,000 in tax-exempt interest on private activity bonds. The parents are subject to the alternative minimum tax for the year, and their regular marginal rate is 28 percent. The child's regular tax on the net unearned income is $2,800. Under the proposed law, the child's minimum tax will be $1,400 (21 percent of $20,000 less $2,800).

The regulations also do not specify what happens in situations where there is a parent but no custodial parent. This can happen when a child lives with a grandparent, guardian or foster parent.

Planning Strategies

While permanent regulations or revenue rulings may provide some further guidance, no major changes in the interpretation of the code is expected. Therefore, taxpayers can rely on the new temporary regulations for purposes of planning. Since the "kiddie tax" is only imposed on unearned income over $1,000 for the period the child is under 14,[19] there are many ways to limit the impact of the law. Income from investments for children or grandchildren should be limited to this $1,000 threshold each year until the child reaches age 14.

For children under 14, growth-type investments that produce little or no taxable income are appropriate. The following investments should be considered:

1. Growth-oriented stocks or securities that do not pay dividends
2. Undeveloped land that is expected to appreciate in value and can be held for long-term appreciation
3. Stock in a closely held family business paying small dividends
4. Deep discount public purpose municipal bonds that mature

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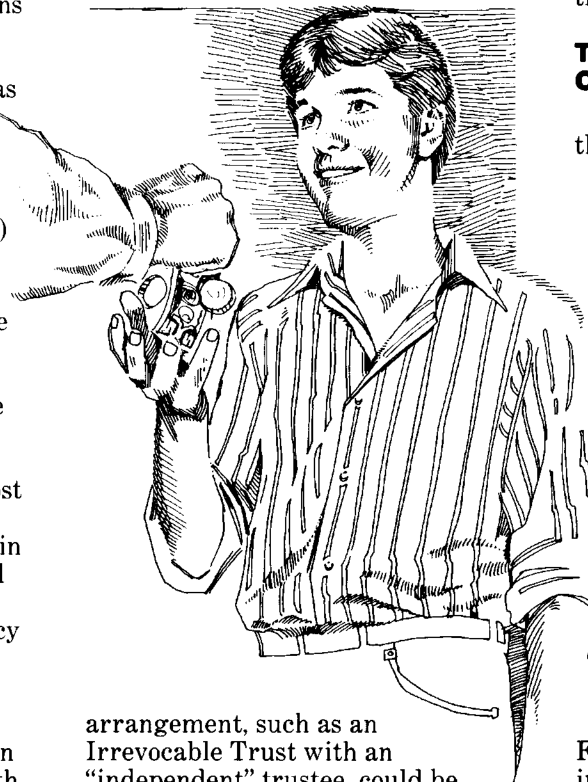
on or after the child is 14

5. United States EE Savings Bonds maturing after the child is 14. (There will be no tax to pay until the bond is redeemed. The gain will then be taxed at the child's lower tax rate. There is a restriction on this option if the child owns existing government bonds and is currently reporting each year's interest accrual as income. Once the election is made to report income currently, it is binding on additional investments in government savings bonds.[20])
6. Single premium life insurance policies. (Because earnings on these policies are not currently taxed, they make excellent investments for children under 14. Single premium ordinary life insurance policies can be purchased at a reasonable cost based on the child's age. The income on the cash build-up in the policy is not taxable until the policy is surrendered.[21] Once the child is 14, the policy can be surrendered and the income will be taxed at the lower rate.)

There are two important ways in which a child could acquire growth assets. They can be purchased with cash gifts up to the annual $10,000 of gift exclusion[22] ($20,000 if joint gift splitting is elected) or purchased jointly with the parent having a life interest and the child a remainder interest.[23] Up to $20,000, under the gift-splitting rules, may be deposited to the trust each year without having to pay a gift tax.

Also, parents can employ the child in the family business. A child with sufficient earned income is entitled to a standard deduction of $3,000 in 1988 and an IRA deduction of $2,000.[24] Thus, a child could earn up to $5,000 in 1988 without incurring any tax liability. If the family business is a sole proprietorship, children under 18 years of age do not pay social security taxes.[25]

In addition, some form of trust



arrangement, such as an Irrevocable Trust with an "independent" trustee, could be used by the parents to make annual gifts to the trust for the irrevocable benefit of the child. The trustee has authority to accumulate all or part of the income each year. The provisions of Sec. 2503(c) requiring the principal to be distributed when the minor reaches the age of maturity (normally age 21) insures that the gift is classified as a present interest for gift tax purposes. Up to $20,000, under the gift-splitting rules, may be deposited to the trust each year without having to pay a gift tax.

Also a Grantor Income Trust (GIT) which retains for the grantor the right to all trust income for a period of years could be used.[26] At its expiration, all income and principal pass to the child at age 14. The appreciation will not be included in the grantor's estate provided the grantor survives the trust term.

Tax Facts to Complete Form 8615

The following example illustrates the mechanics of the "kiddie tax":

> James and Ruth Norris have a 13-year-old son, Fred. Mr. and Mrs. Norris have $90,000 of 1988 taxable income. Fred received $5,000 of dividend and interest income from a trust established by his grandparents and $1,200 from part-time jobs. Fred did not incur enough expenses to itemize his 1988 deductions. Fred has a 9-year-old sister, Jean, and a 16-year-old brother, Richard, both of whom also have $5,000 of dividend and interest income from trusts.[27]

The information to complete the kiddie tax Form 8615 for Fred Norris is illustrated in Table 1.

The first step is to calculate Fred's net investment income. His investment income on line 1 is picked up from line 30 of his Form 1040. Fred enters $1,000 on line 2 since he has no itemized deductions. Line 5 is the net investment income.

The second step is to calculate the tentative tax based on his parent's rate. His parent's taxable income of $90,000 is entered on line 6. His sister Jean's net investment income is entered on line 7. Richard's income is not included because he is over the age of 13. The sum of the parent's taxable income and the net investment income of their under age 14 children is entered on line 8.

TABLE 1

Form **8615**

Department of the Treasury
Internal Revenue Service

Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000

▶ See instructions below and on back.
▶ Attach ONLY to the Child's Form 1040, Form 1040A, or Form 1040NR.

OMB No 1545-0998
1988
Attachment Sequence No **33**

General Instructions

Purpose of Form. For children under age 14, investment income (such as taxable interest and dividends) over $1,000 is taxed at the parent's rate if the parent's rate is higher than the child's rate.

Do not use this form if the child's investment income is $1,000 or less. Instead, figure the tax in the normal manner on the child's income tax return. For example, if the child had $900 of taxable interest income and $200 of income from wages, Form 8615 is not required to be completed and the child's tax should be figured on Form 1040A using the Tax Table.

If the child's investment income is more than $1,000, use this form to see if any of the child's investment income is taxed at the parent's rate and, if so, to figure the child's tax. For example, if the child had $1,100 of taxable interest income and $200 of income from wages, Form 8615 should be completed and attached to the child's Form 1040A.

Investment Income. As used on this form, "investment income" includes all taxable income other than earned income as defined on page 2. It includes income such as taxable interest, dividends, capital gains, rents, royalties, etc. It also includes pension and annuity income and income (other than earned income) received as the beneficiary of a trust.

Who Must File. Generally, Form 8615 must be filed for any child who was under age 14 on January 1, 1989, and who had more than $1,000 of investment income. If neither parent was alive on December 31, 1988 do not use Form 8615. Instead, figure the child's tax based on his or her own rate.

Additional Information. For more information about the tax on investment income of children, please get **Pub. 929**, Tax Rules for Children and Dependents.

(Instructions continue on back.)

Child's name as shown on return	Child's social security number
Fred Norris	119 : 24 : 8234
Parent's name (first, initial, and last). (Caution: See instructions on back before completing.)	Parent's social security number
James Norris	118 : 32 : 4263

Parent's filing status (check one): ☐ Single, ☒ Married filing jointly, ☐ Married filing separately, ☐ Head of household, or ☐ Qualifying widow(er)

Enter number of exemptions claimed on parent's return ▶ ☐

Line	Description		Amount
Step 1	**Figure child's net investment income**		
1	Enter the child's investment income, such as taxable interest and dividend income (see Instructions). (If this amount is $1,000 or less, stop here; do not file this form.)	1	5,000
2	If the child DID NOT itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter $1,000. If the child ITEMIZED deductions, see the Instructions	2	1,000
3	Subtract the amount on line 2 from the amount on line 1. Enter the result. (If zero or less, stop here; do not complete the rest of this form but ATTACH it to the child's return.)	3	4,000
4	Enter the child's **taxable** income (from Form 1040, line 37; Form 1040A, line 19; or Form 1040NR, line 36)	4	5,000
5	Compare the amounts on lines 3 and 4. Enter the smaller of the two amounts ▶	5	4,000
Step 2	**Figure tentative tax based on the tax rate of the parent listed above**		
6	Enter the parent's **taxable** income (from Form 1040, line 37; Form 1040A, line 19; Form 1040EZ, line 7; or Form 1040NR, line 36)	6	90,000
7	Enter the total, if any, of the net investment income from Forms 8615, line 5, of ALL OTHER children of the parent. (Do not include the amount on line 5 above.)	7	4,000
8	Add the amounts on lines 5, 6, and 7. Enter the total	8	98,000
9	Tax on the amount on line 8 based on the **parent's** filing status (see Instructions). Check if from ☐ Tax Table or ☒ Tax Rate Schedules	9	24,878
10	Enter the parent's tax (from Form 1040, line 38; Form 1040A, line 20; Form 1040EZ, line 9; or Form 1040NR, line 37). Check if from ☐ Tax Table or ☒ Tax Rate Schedules	10	22,238
11	Subtract the amount on line 10 from the amount on line 9. Enter the result. (If no amount is entered on line 7, enter the amount from line 11 on line 13; skip lines 12a and 12b.)	11	2,640
12a	Add the amounts on lines 5 and 7. Enter the total — 12a: 8,000		
b	Divide the amount on line 5 by the amount on line 12a. Enter the result as a decimal (rounded to two places)	12b	× .50
13	Multiply the amount on line 11 by the decimal amount on line 12b. Enter the result ▶	13	1,320
Step 3	**Figure child's tax**		
	Note: *If the amounts on lines 4 and 5 are the same, skip to line 16*		
14	Subtract the amount on line 5 from the amount on line 4. Enter the result — 14: 1,000		
15	Tax on the amount on line 14 based on the **child's** filing status (see Instructions). Check if from ☒ Tax Table or ☐ Tax Rate Schedule X	15	152
16	Add the amounts on lines 13 and 15. Enter the total	16	1,472
17	Tax on the amount on line 4 based on the **child's** filing status. Check if from ☒ Tax Table or ☐ Tax Rate Schedule X	17	754
18	Compare the amounts on lines 16 and 17. Enter the **larger** of the two amounts here and on Form 1040, line 38; Form 1040A, line 20; or Form 1040NR, line 37. Be sure to check the box for "Form 8615" ▶	18	1,472

For Paperwork Reduction Act Notice, see back of form. Form **8615** (1988)

The tax on line 8 using the parent's filing status is $24,878 and is entered on line 9. The parent's tax on their return of $22,238 is shown on line 10. The difference between the two is the parental tax shown on line 11. On line 13 is Fred's parental tax (i.e., the tax on his net investment income).

The child's tax is calculated in step 3. The amount on line 14 is Fred's income taxed at his rate of 15%. The amount on line 17, $754, is the tax on Fred's income. The amount on line 18 is Fred's total tax of $1,472.

Compliance

Because of the "kiddie tax," more children will be required to file tax returns. Furthermore, the parent's return will have to be completed before the child's return can be completed. Under the Tax Reform Act of 1986, a custodial parent must provide the child with his or her social security number for inclusion on the child's return.[28] The parent is subject to penalties for failure to comply. In addition, the social security number for minor children age 5 or older must appear on the parent's return.

Radie Bunn *is an associate professor of accounting at Southwest Missouri State University. He has written a number of articles for accounting and professional journals and is a member of the NAA and AAA.*

Craig J. Langstraat, J.D., LL.M. (Taxation), CPA, *is an associate professor in the School of Accountancy at Memphis State University. Professor Langstraat has published over thirty tax articles in various accounting and legal periodicals. He is a member of the Arizona and California Bars, AAA, ATA, and AICPA.*

Conclusion

While the "Kiddie Tax" has restricted income allocation possibilities, there are still sufficient planning strategies available to make income splitting among family members worthwhile. ■

NOTES

1. Tax Reform Act of 1986, P.L. 99-514, October 22, 1986
2. IRC Sec. 1 (i) (2).
3. Temp.Reg. 1.1 (i)-1T, T.D. 8158.
4. Temp. Reg. 1.1 (i)-1T, Q & A 20.
5. Temp.Reg. 1.1 (i)-1T, Q & A 21.
6. Temp. Reg. 1.1 (i)-1T, Q & A 8.
7. Temp. Reg. 1.1 (i)-1T, Q & A 15.
8. Temp. Reg. 1.1 (i)-1T, Q & A 9.
9. IRC Sec. 63 (c) (5).
10. IRC Sec. 1 (i) (4).
11. H. Rep't No 100-391, 100th Cong., 1st session (1987), pp. 2279-2280.
12. Temp.Reg. 1.1 (i)-1T, Q & A 16.
13. Temp. Reg. 1.1 (i)-1T, Q & A 11.
14. Temp. Reg. 1.1 (i)-1T, Q & A 12.
15. Temp. Reg. 1.1 (i)-1T, Q & A 10.
16. Temp. Reg. 1.1 (i)-1T, Q & A 14.
17. Temp. Reg. 1.1 (i)-1T, Q & A 17.
18. Id. at 11, p. 2280.
19. Id. at 2.
20. IRC Sec. 454 (a).
21. IRC Sec. 61 (a) (10).
22. IRC Sec. 2513.
23. Stroebel, Caroline, and Wilson, Patricia, "Income Shifting Opportunities After the 1986 Tax Reform Act, 20 The Practical Accountant, May 1987, pp. 30-39.
24. IRC Sec. 63 (d) and Sec. 219 (b).
25. IRC Sec. 3121 (b) (3).
26. IRC Sec. 673 (a).
27. Individual Tax Return Guide, Federal Tax Coordinator 2d, Section 3, The Research Institute of America, Inc., 1987.
28. IRC Sec. 1 (i) (6).
29. IRC Sec. 6109 (e).

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