The Kiddie Tax

Presented by Christa Canavan

The IRS's kiddie tax rules limit parents' ability to transfer investment assets to a minor child in order to take advantage of the child's lower marginal tax bracket.

The kiddie tax applies to the following groups:

- Children younger than 18
- Children age 18 whose earned income does not exceed one-half of their support
- Children at least age 19 but younger than 24 who are full-time students and whose earned income does not exceed one-half of their support (Students are considered full-time if they were in school full-time during any part of at least five months during the year.)

Changes for 2020 and Beyond

Beginning in 2020, the SECURE Act changed how the kiddie tax is assessed.

Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), if a child's net unearned income was above an indexed threshold, it would be taxed at the parents' tax rate (if the parents' rate was higher). Under the TCJA, if a child's unearned income was above the specified threshold, it would be taxed at rates comparable to trust tax rates. For 2023, the threshold amount is $2,500. With the SECURE Act, however, the kiddie tax reverts to taxing the child's net unearned income at the parent's tax rate, effectively rolling back the TCJA change for 2020 and after.

Tax Planning Strategies

- Consider investments that potentially generate tax-exempt income, such as municipal bonds*; investments that defer tax, such as U.S. savings bonds; or growth-oriented stocks and growth securities.
- If taxable investment income is below the indexed threshold, consider electing to report U.S. savings bond interest each year.
- If the child has earned income, consider investing the assets that are generating taxable investment income in a Roth IRA. Roth IRA qualified distributions generally aren't subject to income tax.

If you decide on the third option, bear in mind that your contributions are not tax deductible because you can invest only after-tax dollars in a Roth IRA. If you meet certain conditions, your withdrawals will be free from federal income tax, including both contributions and investment earnings. To be eligible for these qualifying distributions, you must meet a five-year holding period requirement and one of the following must apply:

- You have reached age 59½ by the time of the withdrawal.
- The withdrawal is made because of disability.
- The withdrawal (of up to $10,000) is made to pay first-time homebuyer expenses.
- The withdrawal is made by your beneficiary or estate after your death.

*Municipal bonds are federally tax free but may be subject to state and local taxes, and interest income may be subject to the federal alternative minimum tax (AMT).

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