

## **June 11, 2007 - Kiddie tax extended to students under age 24!**

**What is the kiddie tax and do I care?** If you don't have children or grandchildren under age 24, you don't care. If you do, read on for some kid-oriented estate planning ideas, including saving for college.

In the old days, say 25 years ago, parents and grandparents who were transferring wealth to younger generations as part of their estate planning got an extra bonus because the income on the transferred assets was taxed to the youngsters at what were usually lower income tax rates. (Unless Junior already had a significant trust fund, the combination of his summer job and the income from these gifts was not going to put him in a tax bracket equal to that of his parents or grandparents.)

Even families with more modest assets could see the advantage in "using" Junior's tax bracket to "shelter" the income being earned on what they were saving for his college education. So they put the college savings account in Junior's name or, if they were a little less trusting, in a simple trust for Junior that taxed all the income to him.

Of course, Congress didn't like this idea. So, in 1986, the "kiddie tax" was enacted. This law requires (basically) that the net "unearned" (investment) income of a child under a certain age be taxed at the parents' higher tax bracket. (A de minimis amount of net unearned income is exempt from the rule each year. In 2007 that amount is \$1,700.) It does not matter whether the child is claimed as a dependent by either parent. The calculation of the child's tax on Form 8615, attached to the child's return, can get very complex. In some cases, the parents might want to, and can, simply elect to report their child's net unearned income on their own return, but doing so can affect parental tax issues such as threshold amounts.

When enacted in 1986, the kiddie tax applied to children under age 14, a group not likely to have earned income, be married, or have other issues of emancipated taxpayers complicating their returns.

In 2006, however, Congress applied the kiddie tax to those under 18 who did not file a joint return. (So a married 17-year-old filing a joint return does not have to apply his parents' higher tax bracket.)

Now, Congress has raised the age limit to 18, or 24 for full-time students. The change, coming so soon after last year's age limit increase, might have been prompted by the impending tax rate drop on long-term capital gains and most dividends in 2008. Currently, the top tax rate on that kind of income is 15% but for lower-income taxpayers that rate is only 5% this year and zero next year. Some families were planning to give stock to Junior, who would sell it as a college freshman in 2008 with no tax on the capital gain.

But 20-somethings can have complex lives, with real jobs and spouses. So the rules designed to separate the trust-fund babies from the emancipated savers get more complex. Starting in 2008, the kiddie tax will apply to:

- children under age 19 and

- full-time students under age 24,
- whose earned income does not exceed one-half of their support and
- who do not file a joint return with a spouse.

The IRS provides the following comprehensive publication, which includes a discussion of the kiddie tax, prior to the recent changes:

Publication 929 (2006), Tax Rules for Children and Dependents

<http://www.irs.gov/pub/irs-pdf/p929.pdf>

**What can I do about it?** One simple solution is to focus Junior's investments on growth rather than income. But if the goal is to sell those investments and use the proceeds for college, the capital gains will be subject to the kiddie tax. On the other hand, in the years since the kiddie tax was originally enacted, Congress has given us a number of tax-advantaged savings plans designed specifically for education. In addition, a young adult with earned income can use a Roth IRA for general purpose tax-advantaged savings.

These planning techniques are discussed in the paper, [Saving for College and Beyond: Tax-Advantaged Ways for Parents and their Young Adults to Build a Nest Egg](http://www.roundinglaw.com/PDFs/saving_for_college_and_beyond.pdf), in our Library.

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