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Abstract: Under the Tax Cuts and Jobs Act, children with unearned income may find themselves in a tax bracket higher than that of their parents. At the same time, the law creates new opportunities for family income shifting. This article provides an overview of the changes to the "kiddie tax" and some strategies for income shifting that are still effective.

Kiddie tax: New hazards, new opportunities

Despite its name, the "kiddie tax" is far from child's play. And a change made by the Tax Cuts and Jobs Act (TCJA) puts some adult teeth into the tax. Now, children with unearned income may find themselves in a tax bracket higher than that of their parents. At the same time, the TCJA creates new opportunities for family income shifting.

Income shifting discouraged

At one time, parents could substantially reduce their families' tax bills by transferring investments or other income-producing assets to their children in lower tax brackets. To discourage this strategy, Congress established the kiddie tax in 1986. The tax essentially eliminated the advantages of income shifting by taxing all but a small portion of a child's unearned income at his or her parents' marginal rate.

When the kiddie tax was first enacted, it applied only to children under 14, but in 2007 Congress raised the age threshold to 19 (24 for full-time students). Note that the kiddie tax doesn't apply to children who reach 19 (or 24, if applicable) by the last day of the tax year. In addition, the tax doesn't apply to children who either 1) are married and file joint returns, or 2) are 18 or older and have earned income that exceeds half of their living expenses.

Tax bite bigger

Now the kiddie tax applies according to the tax brackets for trusts and estates, rather than at the parents' marginal rate. In previous years, the kiddie tax essentially undid the benefits of shifting investment income to one's children. By applying the parents' marginal rate to that income, the tax result was about the same as if the parents had retained ownership of the assets.

But the TCJA's approach can push children into a tax bracket higher than that of their parents in many cases. That's because, for 2019, the highest marginal tax rate for trusts and estates — currently, 37% — kicks in when taxable income exceeds $12,750. For individuals, that rate doesn't apply until taxable income reaches $510,300 ($612,350 for joint filers).

Planning opportunity

Although the new kiddie tax rules can lead to harsh consequences for many families, they may create tax-saving opportunities for higher-income taxpayers. Because the tax is now applied using the progressive rate structure for trusts and estates, rather than the parents' marginal rate, parents can shift a limited amount of investment income to their children at lower tax rates. For example, parents in the 37% tax bracket can shift income up to $14,950 (the $2,200 unearned income threshold plus $12,750) before the 37% rate applies.

There are also several ways to shift income to your kids without triggering kiddie tax issues. For example, you can:

- Transfer investments that emphasize capital appreciation over current income, allowing the child to defer income until the kiddie tax no longer applies,
- Transfer tax-deferred savings bonds,
- Transfer tax-exempt municipal bonds,
- Contribute to 529 college savings plans, and
- Hire your kids.

Employing your children can be beneficial because earned income isn't subject to kiddie tax; plus, your business can deduct the expense.

Look before leaping

Depending on your circumstances, shifting income to your children may reduce your tax bill. But given the risk that income-shifting may increase it, look closely at the kiddie tax before you attempt this strategy.