"Kiddie Tax" Moves into College Years

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Special rules can apply when your child has unearned income. These "kiddie tax" rules may tax a portion of your child's unearned income at your (presumably higher) marginal tax rate. Legislation signed into law in May expands the potential reach of the kiddie tax rules to college-aged children, prompting many parents to rethink gifting strategies.

Kiddie tax basics

Generally, the kiddie tax rules apply when a child has unearned income exceeding $1,700 (2007 figure). What's unearned income? It's income other than wages, salary, professional fees, or any other compensation for services. Interest and investment earnings are considered unearned income, as is taxable gain that results from the sale of an asset.

Prior to the Small Business and Work Opportunity Tax Act of 2007, the kiddie tax rules applied to children under the age of 18. Beginning in 2008, however, the new legislation expands the kiddie tax rules to apply to children who are under age 19, and to full-time students under age 24. There's an exception carved out for any child who earns more than one-half of his or her own support.

Why the change?

The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the tax rate on long-term capital gains and qualifying dividends. Specifically, the act established a 15% tax rate for individuals in the higher tax brackets and a 5% rate for individuals in the bottom two tax brackets. Even more significantly, beginning in 2008, the tax rate on long-term capital gains and qualifying dividends drops to zero for individuals in the lowest two tax brackets (this zero tax rate remains effective for tax years through 2010).

The zero tax rate applicable to individuals in the lower tax brackets presented a real planning opportunity. You could transfer appreciated investment assets to your child attending college. Since your child would likely be in the lower two tax brackets, he or she could then sell the assets in the year he or she turned 18, and use the resulting proceeds--tax free--to pay college expenses.

Impact of the new legislation

By expanding the kiddie tax rules to include full-time students under age 24, the Small Business and Work Opportunity Tax Act of 2007 eliminates or greatly limits this planning opportunity for most families. Starting next year, if your child is a full-time student (who does not earn more than one-half of his or her own support), the kiddie tax rules will kick in if your child sells an investment asset before the year in which he or she reaches age 24. The resulting income--at least the portion that exceeds $1,700 with an adjustment for inflation--will be taxed at your (presumably higher) tax rate, eliminating most or all of any potential tax savings.

We believe that a successful wealth management relationship starts with clarity of purpose.

Before embarking on any plans or strategies with our Client, we first seek to develop a clear understanding of your personal and financial goals.

We then work with you to select and implement strategies that will help you move toward your goals.

A final word

Like many IRS rules, kiddie tax rules are complicated. We strongly suggest that you contact your own tax advisor before making any changes or decisions.
We would be glad to have a conversation with you about some options that may help you in your college planning. Please give us a call. With warm regards,

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