Four Ways to Downsize the Kiddie Tax

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Don't be fooled by the term commonly used to describe an extra tax liability a family may have to pay. The so-called "kiddie tax" is not limited to children in diapers or even those in the lowest school grades. It may continue to apply to children well into their 20s. Fortunately, there are several ways to minimize or even eliminate this additional tax.

Basic Rules

Generally, income is taxed at the tax rate of the individual who receives it. For example, if you are in the 39.6% tax bracket, your top dollars are taxed at the 39.6% rate. On the other hand, if your child is in the 10% bracket, the child pays tax at a maximum rate of only 10%.

However, a special rule applies to certain children who receive unearned income above an annual threshold. In this case, the excess is taxed at the top tax rate of the child's parents. Thus, instead of being taxed at the 10% rate, your child may be taxed at the 39.6% rate on the excess.

The annual threshold is adjusted for inflation, but recent increases have been small or nonexistent. For 2014, the threshold is $2,000, the same as it was in 2013.

Another Problem

Initially, the kiddie tax only applied to children younger than age 14, but the limit has been raised several times. Currently, the age limit is age 19 or age 24 for a full-time student if the child does not have earned income in excess of half of his or her annual support. In other words, if your dependent child is in college, the kiddie tax likely still applies.

How can you reduce the impact? Here are four ideas to consider.

1. Keep your child's unearned income below or near the $2,000 threshold. For instance, you might wait until next year to give your child some income-producing property. This technique works especially well if you do not expect your child to pay the kiddie tax in 2014.
2. Utilize tax-deferred investments that don't produce current income. This may include investments in growth stock and U.S. Savings Bonds. Similarly, if the child buys certificates of deposit (CDs) or Treasury bonds that will not mature until next year, you can avoid or minimize the kiddie tax this year.

3. Allocate a portion of your child's investment portfolio to municipal bonds ("munis") or muni bond funds. Generally, the income received from these investments is completely free of federal income tax, so your child can pocket any amount without kiddie tax worries.
4. Hire your child to work for your company. Because the wages constitute earned income, this will not trigger any kiddie tax complications. As long as the child is paid a reasonable salary for the services performed, your company can deduct the wages. This is a good way to help a child save money for college without adverse tax consequences.

If your child owes the kiddie tax for 2013, you may elect to have the extra income reported on your 2013 return if certain conditions are met. Contact your Henry & Horne, LLP tax adviser for more details.

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