The Savage Truth: Understanding the kiddie tax

by Terry_Savage

Consider this news to be another step in the Tax Accountants Full Employment Act. The latest change in the tax law: The "Kiddie Tax" now applies to much older kids! The new tax law puts a crimp in the plans of wealthy parents who had planned to gift highly appreciated stocks to their college-age children, who could then sell the shares and pay a very low capital gains tax rate based on their low income.

Raising the age threshold until 2005, the tax on a child's unearned income, such as dividends, interest and capital gains, was paid at the parents' marginal rate if the child was under age 14. But last year, the age limit was raised, requiring children under age 18 to be taxed at the parents' rate. And starting in tax year 2008, the age limit will apply to children under age 19 â€” or to "kiddies" who are full-time students under the age of 24.

(Note: This rule does not apply to "earned income," such as from a summer job, or even to a baby who earns modeling fees. That earned income can still be reported on a child's separate return, and taxed at the child's lower rate.)

The concept of gifting appreciated stock to children who would pay lower tax rates was considered a "loophole" by the pro-tax lobby, who believes all income belongs to the government, and it will decide how much you can keep.

By closing that opportunity, the government expects to collect as much as $1.5 billion in extra tax revenues over the next 10 years.

This "loophole" has been a particularly enticing opportunity in recent years, because of capital gains rates that have been dropping for those in the lowest two brackets (10 percent and 15 percent).

The maximum capital gains tax rate on assets held for at least one year is 15 percent â€” no matter what your ordinary income tax bracket (with a few exceptions for collectibles and some other assets). But for those in the lowest two brackets in tax year 2007, the maximum tax on capital gains is only 5 percent.

(For 2007, on an individual return, that 10 percent bracket applies to those who have taxable income less than $7,825. The 15 percent tax bracket tops out at taxable income of $31,850.)

In 2008, it would have been an even better deal, because in 2008, the capital gains tax rates will drop to zero â€” yes, you read correctly: zero percent â€” for those in the lowest two tax brackets. This zero rate will be particularly helpful to low-income senior citizens who may have to sell long-held stocks to pay living expenses. Now parents who want to transfer appreciated stocks to low-income kids â€” who would be able to cash in at the lowest or zero capital gains rates â€” will find themselves locked out of this deal.

Mark Luscombe, principal tax analyst at CCH, says there are a few exceptions: "These kiddie tax rules do not apply to a child who is married and files a joint return. And a new rule says the kiddie tax does not apply if the child's own earned income provides more than one-half of their support."

But Luscombe goes on to point out: "This has really frustrated efforts to transfer assets to children to fund college tuition expenses.

But it is still useful for parents who want to transfer assets that their children can hold until the first year after graduation â€” before they are earning a big salary. Then the grad can sell at his own lower tax rate â€” and use the proceeds to pay off student loans."

As long as there is a Congress, there will be new tax rules. And there will be accountants to figure out a way around them.

Surely, we could put all this expensive talent to better use! The flat tax or national sales tax look more appealing every day.

And that's The Savage Truth.

Terry Savage is a registered investment adviser and is on the board of the Chicago Mercantile Exchange. She appears weekly on WMAQ-Channel 5's 4:30 p.m. newscast, and her new book, "The Savage Number: How Much Money Do You Make?" has just been published.