Don't Let the Kiddie Tax Get You

The term "kiddie tax" was introduced by the Tax Reform Act of 1986. The IRS introduced this rule to keep parents from shifting their investment income to their children to have this income taxed at their child's lower tax rate. The kiddie tax law requires a child's unearned income (generally dividends, interest, and capital gains) above a certain amount ($2,000 in 2014) to be taxed at their parents' tax rate. Here is what you need to know.

Who it applies to

- Children under the age of 19
- Children under the age of 24 if a full-time student and providing less than ½ of their own financial support
- Children with unearned income above $2,000

Who/What it does NOT apply to

- Earned income (wages and self-employed income from things like babysitting or paper routes)
- Children that are over age 18 and have earnings providing more than ½ of their support
- Older children married and filing jointly
- Children over age 19 that are not full-time students
- Gifts received by your child during the year

How it works

- The first $1,000 of unearned income is generally tax-free
- The next $1,000 of unearned income is taxed at the child's (usually lower) tax rate
- The excess over $2,000 is taxed at the parents' rate either on the parents' tax return (Form 8814) or on the child's tax return (Form 8615)

Some Ideas

1. **Maximize your low tax investment options.** Look to generate gains on your child's investment accounts to maximize the use of your child's kiddie tax threshold each year. You could consider selling stocks to capture your child's investment gains and then buy the stock back later to establish a higher cost basis.

2. **Be careful where you report a child's unearned income.** Don't automatically add your child's unearned income to your tax return. It might inadvertently raise your taxes in surprising ways by exposing more income to the Alternative Minimum Tax or reducing your tax benefits in other programs like the American Opportunity Credit.

3. **Leverage gifts.** If your children are not maximizing their tax-free investment income each year consider gifting funds to help create unearned income up to the kiddie tax thresholds. Just be careful, as these assets can have an impact on a child's financial aid when approaching college age years.

Properly managed, the "kiddie tax" rules can be used to your advantage. But if not properly managed, this part of the tax code can create an unwelcome surprise at tax time.

Understanding these "kiddie tax" rules should be part of your mid-year planning exercise.

Severance Pay Now Deemed Wages

A recent Supreme Court decision clarifies that severance payments you receive when you leave your job are wages and thus subject to employment taxes. How might this impact you?

Background

The taxes impacted by this decision consist of two components:

- **Social Security.** 12.4% of wages up to $117,000 in 2014 are paid as Social Security tax. 6.2% of this is paid by the employee and 6.2% is paid by the employer.
- **Medicare.** 2.9% of all wages are paid as Medicare tax. Half is paid by the employee and half is paid by the employer. There is also a potential Obamacare Medicare tax surcharge if your wages exceed $200,000 single and $250,000 married.

Many employers who pay a severance check to employees when they leave have been classifying these checks as other, non-wage, income. This allowed both the employer and employee to save on paying these payroll taxes.

What you should know

The Supreme Court ruling now subjects this severance to payroll taxes and the IRS estimates that $1 billion in potential wages are impacted by this decision. Knowing this, here are some things to consider.

- **The 1099 flag.** If you receive a check without a payroll stub, you will probably be receiving a 1099 in the future. If this is the case, you could be responsible for the employer portion of Social Security and Medicare tax as well as your own. To avoid this unpleasant surprise, ask for clarification from your former employer. Have the payment reissued as wages, if appropriate.
- **Check withholdings.** If you leave your job ensure all payments to you are shown as wages on a W-2. Check your last payroll check to see that the correct Social Security and Medicare taxes have been withheld.
- **Other things to check.** While you are at it, review the final employer paycheck for payment of unused vacation per the company's employment policy. When you check for withholdings on your last paycheck also ensure the level of withholding is at the level you requested on your normal paycheck. Often these last checks use withholding defaults versus the level you requested on your W-4.

This publication provides summary information regarding the subject matter at time of printing. Please call with any questions on how this information may impact your situation.