The "kiddie tax" rule—changed again

In late May, as part of legislation that increased the minimum wage and provided funding for the Iraq war came a modification of the "kiddie tax" rules that may have flown under the radar for many people.

A little background

In the past, families with means sought to reduce their tax exposure by transferring income-producing assets to their children. The advantage of this strategy is simple: The income from the assets then would be taxed in the children's lower-income tax bracket, reducing the family's overall tax burden.

Congress saw fit to limit the potential tax savings for some families by introducing a new rule, now known as the "kiddie tax." The unearned income—interest, dividends and capital gains—of children under the age of 14 became taxable at their parents' rate above a certain threshold amount, adjusted annually for inflation. In 2005 the rule was changed to apply to children under the age of 18. There is an exemption available, indexed to inflation: For 2007, the rule applies only to unearned income in excess of $1,700.

Here's the new rule

Beginning in 2008, the kiddie tax will apply to full-time students under the age of 24. The rule *won't* apply to students who provide over one-half of their own support from their earned income (wages, tips, commissions, etc.).

It's likely not a coincidence that the latest adjustment to the kiddie tax coincides with a drop from 5% to 0% in the long-term capital gain rate for investors in the 10% and 15% tax brackets, also beginning in 2008.

Timing offers a short-term opportunity

College students over the age of 18 should consider selling appreciated assets before the end of this year, in order to take advantage of the 5% rate—as opposed to the higher 15% rate that will have to be paid if the gain is taxed at their parents' rate next year.

Families with young children may want to put their focus on another tax-saving possibility—making contributions to a Section 529 plan or Coverdell Education Savings Account. Both offer the chance to accumulate funds for college tax free and, subject to certain conditions, to pay college expenses tax free as well. By investing a 529 plan outside of the state in which you pay taxes, you may lose tax benefits offered by the state's plan. Withdrawals used for qualified expenses are federally tax-free. Tax treatment at the state level may vary.

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