Taxing Teens: Working Children, Family Businesses, and the Kiddie Tax

Joyce Beebe, Ph.D., Fellow, Center for Public Finance

Being able to manage money is an important life skill, but many American youth are not well prepared to do so. A recent Organisation for Economic Co-operation and Development (OECD) study shows that more than 20% of U.S. high school students do not possess basic levels of financial literacy. This means they can at best identify basic financial products such as invoices or make simple decisions on every day spending. But the ability to create a simple budget, conduct calculations in percentages, appreciate compound interest on savings or loans, and understand income taxes are all beyond their comprehension.

How should parents teach their kids about money? Parents can draw ideas from endless references, including their own experiences, family and friends’ suggestions, and tons of publications written by personal finance experts, journalists, and successful entrepreneurs. Repeated themes from these resources include putting your kids to work so they can earn money and develop solid work ethics, teaching them to set money aside for savings and investments so they understand delayed gratification, and helping them understand how to correctly follow the tax system so they become responsible citizens. This report reviews different types of income sources for kids and young adults and the associated tax implications. It also discusses the revised kiddie tax rules after the 2017 tax act (TCJA, Pub. Law 115–97).

PUTTING YOUR KIDS TO WORK FOR OTHERS

The most common way a child can earn money is through formal and informal jobs. The OECD study indicates that about 55% of U.S. high school students surveyed received work-related income (including pay from holiday jobs, babysitting, gardening, or any part-time work), and about the same percentage held a bank account. College students are likely to have income from internships and summer jobs. However, with the excitement of receiving their first paycheck comes a reality check as kids see how much their take-home pay can shrink from withholding taxes, including federal income taxes, state and local income taxes, and FICA taxes (Federal Insurance Contributions Act, which finances Social Security and Medicare).

The Tax Cuts and Jobs Act (TCJA) increased the standard deduction for single filers from $6,350 in 2017 to $12,000 in 2018, which means that if a child earns more than $12,000 in labor income in 2018, or approximately $1,000 per month, he will need to file a federal income tax return (Form 1040). The filing process may not be as daunting as parents’ filing requirements because the child may be able to use the simpler Form 1040-EZ should he meet certain criteria. Two conditions that would disqualify a child from using Form 1040-EZ would be if he claims an individual retirement account (IRA) deduction or has...
One way children can reduce their taxable income further is to engage in retirement savings. As long as a child has earned income, he can contribute to an IRA up to the $5,500 annual contribution limit or 100% of his earned income, whichever is less. Earned income generally includes salaries, wages, tips, professional fees, and other payment taxpayers receive for work performed, as opposed to unearned income, which includes interest, royalties, dividends, rental income, and capital gains and cannot be used for contributions to an IRA.

For contributions to traditional IRAs (aka “pre-tax IRAs” in which the contributions are tax-deductible, as opposed to “after-tax” Roth IRAs for which taxpayers do not receive deductions for the contributions), the tax deductibility starts to phase out at $63,000 for single taxpayers. Most children do not earn enough income to lose the deductibility. Alternatively, some may opt to start a Roth IRA to take advantage of the low tax rate during low-income years.

Because early withdrawals from IRAs that are used for qualified higher education expenses are not subject to a 10% additional tax penalty, some parents view this as a vehicle to fund their children’s college tuition. The most recent IRS statistics show that in 2015, about a third of taxpayers who took early distributions from qualified retirement plans did not pay the 10% penalty, withdrawing $8.7 billion in aggregate.

Although this strategy is allowed, it may not be desirable. Specifically, even if such withdrawals are not subject to the 10% penalty, the early distribution is still taxable income and would increase an individual’s tax liability. In addition, early withdrawals can affect students’ need-based financial aid. The Roth IRA has the advantage of allowing account owners to withdraw contributions for any reason without tax consequences, but the rules get complicated when account owners tap into the earnings portion of such accounts.

### Investment Implications

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Taxable Income</th>
<th>Tax Rate</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$0 to $9,325</td>
<td>10%</td>
<td>$0 to $9,525</td>
</tr>
<tr>
<td>15%</td>
<td>$9,326 to $37,950</td>
<td>12%</td>
<td>$9,526 to $38,700</td>
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<tr>
<td>25%</td>
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<td>32%</td>
<td>$157,501 to $200,000</td>
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<td>35%</td>
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<td>$200,001 to $500,000</td>
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<tr>
<td>39.60%</td>
<td>Over $418,401</td>
<td>37%</td>
<td>Over $500,000</td>
</tr>
</tbody>
</table>

**Source:** Internal Revenue Bulletin 2018-10, IRS, March 2018; Revenue Procedure 2016-55, IRS, October 2016.
Employee or Contractor?

One may wonder if it would be easier to avoid withholding taxes on a child’s labor income by requesting that the employer treat the child as an independent contractor, therefore issuing him a Form 1099 instead of a W-2, since it is likely the child would either not need to file a return or not request a refund. But there are at least two issues with this thinking. First, there are specific rules that determine whether a worker is an employee or an independent contractor, and misclassification without a reasonable justification will lead to penalties such as repayment of back taxes, interest, and fines. Second, if in fact it is reasonable to treat a child as a contractor, this means federal income tax rules would view him as a self-employed individual, and he will need to file quarterly estimated payments and pay a 15.3% self-employment tax in addition to filing the Form 1040 that is due annually in April. In other words, the independent contractor status may not make tax filing more straightforward.

A child would be considered an independent contractor if she is truly self-employed. This could include entrepreneurial-minded children who operate their own “businesses” or participate in the sharing economy by driving for Uber or selling crafts on Etsy. If her self-employed net earnings are more than $400, an income tax return is required. The IRS indicates that even if taxpayers do not receive Form 1099, they are still responsible for reporting net earnings that exceed the $400 threshold.

Keeping it in the Family

Parents are not subject to the FICA tax for kids under age 18 who work for the family business (or the FUTA tax for children under 21), provided that the parents’ business is a sole proprietorship or partnership in which no non-parent partners are involved. If a parent owns a corporation or has a business that he jointly owns with an uncle, for example, he will not enjoy these beneficial tax rules. A child’s wage payments are subject to income tax withholding regardless of age. In addition, a business owner can deduct her children’s wages as business expenses and reduce the entity’s taxable income.

These benefits are most applicable if a taxpayer also has third-party employees on payroll and thus already has a compliance system in place. Employers are required to submit various employee information and regulatory paperwork, including IRS Form W-4 (employees); Forms 940, 941, 945, and W-2; U.S. Citizenship and Immigration Services Form I-9; employees’ Social Security numbers; and the taxpayer’s own Employer Identification Number. Setting up payroll solely to hire one’s children may not justify the extra time and administrative cost.

TABLE 2 — TAXABLE BRACKETS AND TAX RATES FOR TRUSTS AND ESTATES, BY TYPE OF INCOME

<table>
<thead>
<tr>
<th>Income Tax Rate</th>
<th>Taxable Amount</th>
<th>Capital Gains and Qualified Dividends Tax Rate</th>
<th>Taxable Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$0 to $2,550</td>
<td>0%</td>
<td>$0 to $2,600</td>
</tr>
<tr>
<td>24%</td>
<td>$2,551 to $9,150</td>
<td>15%</td>
<td>$2,601 to $12,700</td>
</tr>
<tr>
<td>35%</td>
<td>$9,151 to $12,500</td>
<td>20%</td>
<td>Over $12,700</td>
</tr>
<tr>
<td>37%</td>
<td>Over $12,500</td>
<td></td>
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</tbody>
</table>

NOTE A child’s unearned income from long-term capital gains and dividends are subject to the rates and brackets specified in the right panel. All other types of net unearned income are subject to the rates and brackets specified in the left panel.

costs. The U.S. Small Business Administration also points out that in addition to these federal requirements, state child labor laws may set minimum wages and maximum working hours for children and require employers to coordinate with children’s school schedules, creating further compliance issues for business owners.

Although the IRS does not discourage parents from hiring their own children, the agency is fully aware of the tax benefits such arrangements could provide to parents as well as the potential for abuse. If the IRS determines that a taxpayer’s child does not constitute a bona fide employee, parents will lose the previously deducted wages, which would lead to higher taxable income and potentially penalties and interest. The child may also need to file missed returns and pay taxes on these earnings.

A review of several court cases reveals the “best practices” of hiring children as help in family businesses; these cases also show that when a familial relationship is involved, the court closely scrutinizes the fact patterns. First, the child must be performing “real work” that is ordinary and necessary for a taxpayer’s business. For instance, in a 1967 case involving a family-run staffing services firm, the court commented that some of the work the taxpayers’ three children performed were more like routine family chores than business-related duties, warranting a much lower deduction.

Second, the child needs to be paid for business services performed in a manner that is similar to other third-party employees. The amounts need to be reasonable and, if there are multiple children, reflect children’s age differences and capabilities. Regarding the form of payment, non-cash, traceable methods are better, such as bank deposits to an account in the child’s name, actual checks, or any other method taxpayers use to pay other employees. In another case ruled in 1981, the court sided with the taxpayer in accepting more than 90% of business expense deductions the taxpayer claimed for a 7-year-old child’s participation in a family business but noted that his remuneration should be less than what was paid to his older sibling, who was 12 years old.

In several recent cases, the tax court accepted that the taxpayers’ children actually performed relevant work but disagreed with the form or frequency of payment. Paying a child a flat amount in the beginning of the year, instead of as services are actually rendered, provides no linkage between dates, payments, and hours worked. In one such case, the business owners paid their three children small amounts of money in each of the first three business quarters (several hundred dollars per quarter) followed by a balloon payment (in the range of $10,000 to $24,000) for the last quarter based on the performance of the business. The court denied the vast majority of the deductions because the taxpayers did not pay unrelated employees similar amounts, and the small payments throughout the year indicated that the taxpayers placed little economic value on the jobs their children completed.

Another case involved a taxpayer who paid her three children with her own credit cards, buying them pizzas and tutoring services in exchange for their work in her business. The court did not take issue with the age of the children, the nature of their work, or the timesheet the parent presented to substantiate their work. However, the ruling indicated that the taxpayer needed to demonstrate that the expenses were paid primarily to benefit her business instead of for personal, living, or family purposes, and that there must be a proximate relationship between the claimed expenses and the business activities. As such, the deductions were denied.

Third, formally documenting children’s work with timesheets that indicate the nature of services provided and hours worked will enhance taxpayers’ defense against IRS challenges. In a recent case, three children shredded waste, prepared mailings, answered telephones, photocopied documents, and greeted clients for their mother’s sole proprietorship law firm, but the taxpayer only deducted a $10,000 lump sum each year for all three children without keeping detailed timesheets or work logs. In the end, the court only allowed a $250 deduction each year for each child.

The most common way a child can earn money is through formal and informal jobs. As long as a child has earned income, he can contribute to an IRA.
UNEARNED INCOME AND THE KIDDIE TAX

If a child has unearned income such as interest, royalties, dividends, rental income, or capital gains, the tax treatment would be different from that of earned income, and usually more complicated. This is due to the “kiddie tax” provision implemented by Congress.

Kiddie Tax: 1986–2017

The Tax Reform Act of 1986 initiated the “kiddie tax” as an anti–avoidance mechanism to prevent parents from shifting income by giving assets such as stocks or bonds to their children, thus reducing their own tax liabilities. Because Congress believed that the shifted assets were still under the parents’ control, the kiddie tax law was designed to tax unearned income attributable to a child under the age of 14 at her parents’ marginal tax rate. If her siblings are also subject to the kiddie tax, her tax liability would depend on both the parents’ and siblings’ tax situations. Since the kiddie tax does not apply to earned income, a child’s earned income will be taxed at her own marginal rate, and usually as a single filer.

Since 1986, both the top personal income tax rate and the number of tax brackets have increased, which means the potential tax savings associated with shifting income to children have also increased. In response to this increased incentive, Congress raised the applicable age for the kiddie tax from 14 to 18 in 2006, and again from 18 to a maximum age of 24 in 2008 (the TCJA did not change the age requirement). Under the current rules, the kiddie tax applies when a child is either under 18, between 18 and 19 and earns less than half of her support, or is a full-time student younger than 24 and earns less than half of her support. Support generally includes money spent to cover food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. Thus, to avoid the kiddie tax, a child can age out of the tax, or have enough earned income to provide for herself. In other words, the kiddie tax will not apply if a child turns 18 and her earned income provides at least half of her support. If her earned income is less than half of her support, she can age out of the kiddie tax at 19 if she is not a student. Finally, if her earned income is less than half of her support and she is a student, she will age out of the tax at 24.

Gifts are excluded from a child’s taxable income base for kiddie tax purposes. However, there may be gift tax consequences if the gift exceeds the annual exclusion amount of $15,000, as the gift tax limits the value of gifts a person can make in any given year as well as over his lifetime.

Criticism

Critics argue that the kiddie tax rules were not well-designed and affected both tax-motivated and non-tax-motivated transfers. In addition, the rules impose compliance burdens that involve overcorrection. The kiddie tax also discourages children from saving and investing, since even interest generated by a plain vanilla savings account at a bank would be subject to the kiddie tax. Finally, it creates incentives for children to hold onto appreciated assets until they are no longer subject to the tax.

Because a child’s unearned income above the annual threshold amount (which is $2,100 for both 2017 and 2018) is taxable at her parents’ top marginal rate, her income is essentially stacked on top of the higher earning family members’ income and is subject to the highest marginal income tax rate due to the progressive rate structure. Observers who disapprove of this mechanism believe that the kiddie tax discourages saving and encourages consumption; a kid’s interest income, for example, is taxed at an exceedingly high rate that is inconsistent with her economic situation. If the purpose of the kiddie tax is to discourage adults from shifting income–producing assets to children, it should not affect parents or children’s investment, savings, or consumption decisions; since the tax does, it creates an additional layer of distortion.

In addition to the tax’s impact on investment, it enhances the “lock–in” effects, which refers to taxpayers’ tendency...
to hold onto an appreciated asset to avoid paying capital gains taxes, as the tax system only taxes realized gains. In other words, the kiddie tax may incentivize children to hold the investment until they reach an age at which the higher tax rate would no longer apply. This leads to inefficient decision-making, because without the tax, investors may decide to sell the appreciated assets sooner, therefore contributing to economic activity.

The pre-2018 rule was also criticized for its complexity because a child’s unearned income needs to be added to parents’ taxable income to determine the incremental tax liability; the tax liability is then allocated back to the child’s tax return and subjected to her parents’ marginal rate. Multiple children in the family, the existence of capital gains, and parents who do not file jointly would all further complicate the calculation. In certain cases, even when the parents are subject to the alternative minimum tax (AMT), the children’s unearned income is still taxable at their parents’ marginal tax rates.

The New Kiddie Tax on the Block: The TCJA

In response to these criticisms, the TCJA made several major changes to the kiddie tax. A House of Representatives conference report states that the new rules simplify the kiddie tax by effectively applying ordinary and capital gains rates applicable to trusts and estates to a child’s net unearned income. A child’s tax is therefore unaffected by his parents’ tax situation or his siblings’ unearned income.

So far, practitioners disagree as to whether the new rules will actually simplify the kiddie tax calculation, and whether families will pay less taxes. Most observers believe the new provision is going to simplify kiddie tax compliance because it no longer requires families to combine the unearned income of siblings or half-siblings, and parents’ marginal tax rates and marital status will not affect the kiddie tax calculation. However, some cautioned that the new rule is still very complicated, as the tax code appears to require each child subject to the kiddie tax to construct his own rate table using his earned taxable income and other relevant items. Additionally, a single taxpayer would have to have more than $500,000 in taxable income (Table 1) to be subject to a marginal tax rate of 37% (and for a married couple, more than $600,000), whereas the 37% rate applies to unearned income exceeding $12,500 under the kiddie tax.

Before the TCJA, a child may be subject to her parents’ long-term capital gains and qualified dividends rates of 15% or 20%; after the TCJA, she will pay the trust rate of 15% or 20%, but the income brackets are much more compressed (Table 2, right panel). As a result, the lock-in effect after the TCJA is likely to be equally prominent, if not more so. Some wealth advisors also pointed out that, depending on donors’ objectives, the traditional “leave an IRA to grandchildren” planning mechanism may no longer be tax-advantageous under the new kiddie tax rules. The main advantage of this planning strategy has been that the inherited IRA essentially extended distribution horizons over the beneficiaries’ lifespan, providing decades of asset growth and tax deferral. Many grandparents employ this strategy to help their grandkids pay for college tuition, but the new kiddie tax may impose a large capital gains bill by taxing the realized capital gains at the trust rate. If grandparents would still like to follow this strategy, a Roth IRA would be a better vehicle.

Planning after the TCJA – Is It Not Worth It Anymore?

Some observers argue that the kiddie tax provision receives disproportionate publicity relative to its revenue impact, while others believe that since it is an anti-avoidance tool, tax revenue may not be a good indicator to measure its effectiveness. Most recent IRS statistics show that in 2015, approximately 385,000 kiddie tax returns (Form 8615) were filed, collecting approximately $1 billion in tax revenue. There has been a high fluctuation in kiddie tax revenue; since 1986, the tax collected has ranged from approximately $200 million (2003) to $1 billion (2000, 2012–2015), with an average tax rate of between 16% and 27%.
Although critics dislike the kiddie tax’s distortion of savings and investment decisions, especially for its impact on non-tax motivated transfers, it still leaves room for tax planning. This is particularly true for taxpayers whose objective in transferring assets to their children is not primarily tax driven.

Under the current rules, the first $1,050 of a child’s unearned income is tax-free and the next $1,050 is taxed at a lower rate, usually the child’s own tax rate. This combined $2,100 threshold could still largely cover current annual dividends from a $100,000 investment in an S&P 500 index fund.39

Another approach would be to focus on assets that are more likely to be kiddie tax resistant. Examples include growth stocks and real estate holdings whose capital appreciations can be deferred until a child ages out of the kiddie tax, retirement assets that produce tax-free income (Roth IRA) or tax-deferred income (IRA), and municipal bonds (“munis”) that generate interest that is excludable from gross income.40

Parents who are business owners can legitimately hire their older children (ages 18–24) to perform more complicated functions and pay them higher wages, generating earned income. The potential benefit of having greater earned income is the child can get a higher or even full standard deduction. This benefit equally applies to cases where children have earned income from internships or other third-party jobs. If the child is a student, an additional benefit of having both earned and unearned income is that she may be able to claim certain education credits (such as the American Opportunity Tax Credit and the Lifetime Learning Credit) that would reduce both her tax liability and alleviate the impact of the associated kiddie tax.41

**CONCLUSION**

A large portion of U.S. teens receive work-related income, and many also have non-labor income from either savings, investments, or family asset transfers. They use these resources to finance current consumption, college tuition, retirement savings, and tax payments, among other spending and savings decisions. Teaching kids about managing money is more an art than a science. However, preparing children to follow tax and other regulatory rules requires diligence to thoroughly follow all the requirements, patience in calmly researching the tax code, and an open mind to adapt to occasional changes in the rules and regulations.

**CANADIAN EXPERIENCE**

Canada implemented its kiddie tax legislation (formally known as “tax on split income,” or TOSI) in 2000, which intended to deter income splitting between parents and children by taxing certain types of children’s non-labor income at the top marginal income tax rates. The Canadian rules differ from those in the U.S. primarily in the applicable age, the type of non-labor income targeted, and the tax rate. Specifically, children 17 years or younger who receive dividends from private companies and net business income from trusts and partnerships are subject to the tax, while capital gains are excluded.42 Unlike the pre-TCJA rules in the U.S. that taxed children’s unearned income at their parents’ marginal tax rates, Canada’s kiddie tax uses the highest statutory individual income tax rate.43

In terms of its effectiveness, studies show that the share of dividend income reported by children declined by 86% after the introduction of the kiddie tax, while the share of capital gains tax reported by children simultaneously increased by 70%. This suggests that Canadian parents were clearly responding to the changed tax incentives and switching to an alternative income-splitting technique not subject to the kiddie tax. In 2018, the TOSI was extended to adult children and generally includes dividends or interest paid by a private corporation to an individual from a related business, as well as certain capital gains.44

Although critics dislike the kiddie tax’s distortion of savings and investment decisions, especially for its impact on non-tax motivated transfers, it still leaves room for tax planning.
ENDNOTES


2. This report discusses federal income tax implications; thus, state and local income tax issues are beyond the scope of the research. The author also notes that the 2018 information referenced may change after the IRS issues the final guidance on the tax.

3. The IRS’ Interactive Tax Assistant is a helpful tool; note that the 2018 guidelines have not been released. See https://www.irs.gov/help/ita/do-i-need-to-file-a-tax-return.


Some practitioners devised certain “family management company” work-arounds, which essentially involved setting up a separate pass-through subsidiary to qualify for the beneficial treatment, but cautioned that such an approach is aggressive and certainly adds to the complexity of the overall business structure. Garrett Gunderson, “See The IRS’s Incredibly Generous Tax Benefits For Hiring Your Own Child (Part 2),” Forbes, February 20, 2016, https://www.forbes.com/sites/garrettgunderson/2016/02/20/see-the-irss-incredibly-generous-tax-benefits-for-hiring-your-own-child-part-two/#70c51d7a7243.


Denman v. Commissioner, 48 T.C. 439 (1967). The taxpayers’ three sons performed the following duties at their parents’ staffing services business: washing windows; taking down and cleaning screens; shoveling snow; mowing grass; tending shrubs, trees, and underbrush; assembling various papers; picking up mail; and stuffing, stamping, and labeling envelopes. See https://www.leagle.com/decision/196748748aqtc4391445.

Eller v. Commissioner, 77 TC 934 (1981). The taxpayers ran a small shopping center, trailer parks, and operated lots adjacent to the trailer park to sell trailers. Their three children performed swimming pool maintenance, landscaping, cleaning, minor repairs, minor office duties, and tenant registration activities. See https://www.leagle.com/decision/1981101177bmtc9341942.

Embroidery Express, LLC v. Commissioner, TC Memo 2016–136 (2016). Three of the taxpayers’ five children were assisting in their embroidery business. They cleaned the office, assisted with inventory, helped clean embroidery machines, assisted with repairs, and helped with lawn care. See https://www.leagle.com/decision/intco20160721e33.


Fisher v. Commissioner, T.C. Summary Opinion 2016–10 (2016). The taxpayer also paid her children by depositing their compensation into their 529 College Savings Plan accounts as well as giving them cash. See https://www.leagle.com/decision/intco20160308e77.


IRS, Publication 501: Exemptions, Standard Deduction, and Filing Information.


Note that the filing threshold is much lower and more complicated. For 2017 and 2018, if a child only has unearned income, the filing threshold is $1,050. If a child has both earned and unearned income, she needs to file a return under one of three conditions:
(1) the total exceeds the larger of $1,050 or her earned income plus $350, (2) her earned income is more than the standard deduction, or (3) her unearned income is more than $1,050. See IRS, Publication 929: Tax Rules for Children and Dependents (Washington, D.C.: IRS, 2017), https://www.irs.gov/pub/irs-pdf/p929.pdf, 3.


40. James Smith, “Revised Kiddie Tax Affects Family Gift and College Saving Plans,” Practical Tax Strategies August 2006: 68–79. As the author explains, munis are exempted from the kiddie tax, but this does not produce tax savings because they are tax–free for both adults and children.

41. Smith, “Revised Kiddie Tax Affects Family Gift and College Saving Plans.”

42. The rules do not include any other types of income or assets, such as dividends from public companies, capital gains, bonds, and mutual fund interest.


AUTHOR

Joyce Beebe, Ph.D., is a fellow in public finance at the Baker Institute. Her research focuses on tax reforms in the U.S. and computable general equilibrium modeling of the effects of tax reforms. Her other research interests include wealth accumulation over a person’s lifetime and, generally, how public policies influence decision-making.