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The Kiddie Tax: A Nuisance Solution to a Nonexistent Problem (Special Tax Symposium)

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Puritanism: a nagging fear that someone, somewhere, might be having fun

—H.L. Mencken

I. Introduction

The Tax Reform Act (TRA) of 1986[1] introduced a far-reaching and potentially revolutionary change in the income taxation of the family: the "kiddie tax."[2] Roughly, the unearned income (in excess of the first $1,000)[3] of a child under fourteen years of age is now taxed to the child at the parents' marginal rate. The stated purpose of the new rule was to prevent parents from taking advantage of their children's lower tax rates by means of transferring income-producing capital to them.

The first section of this article describes the kiddie tax itself and analyzes the planning choices it presents. The second section criticizes the new tax as unfairly broad in application, overly complex, and inefficient. The final section questions whether the purported loophole which the kiddie tax addressed ever really existed, and concludes that if it did, it was only because the IRS made no effort to enforce prior law. The article concludes that enforcement of prior law would have been a better approach than enactment of the kiddie tax.

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1. Pub. L. No. 99-514, 99th Cong., 2d Sess. (1986).
2. Internal Revenue Code (I.R.C.) § 1(g) (1986).
3. The statutory amount is indexed for inflation, and the figure for 1995 is $1,300.

II. Mechanics of the Kiddie Tax

A. The Kiddie Tax Return

A child is subject to the kiddie tax under I.R.C. § 1(g) if (1) he has not attained age fourteen before the close of the taxable year, (2) either parent is alive at the close of the taxable year,[4] and (3) the child has net unearned income (NUI), which means unearned income in excess of $1,000 (for 1995, $1,300).[5] The kiddie tax applies only to the child's NUI so that amounts beneath the $1,300 floor are either immunized completely by the child's own standard deduction (the first $650) or taxable at the child's own 15 percent rate (the next $650).[6] The child's *earned* income is always taxed at the child's own rate.

To the extent that the child has NUI, it is taxed to the child at a rate which reflects the highest marginal rate of the parent, or more exactly, it is taxed at the rate which would have been applicable to the parent had the NUI been added to the parent's own income. Thus, if the child's NUI pushes the parent's income into a higher tax bracket, that higher rate is applicable to the child's NUI. The tax on such NUI is called the "allocable parental tax" (APT) and is calculated by determining the excess of (1) the parent's hypothetical tax liability after *including* the child's NUI, over (2) the parent's actual tax liability ignoring the kiddie tax.[7] This hypothetical calculation does not affect the parent's actual tax liability in any way.[8]

If there are two or more children whose NUI must be calculated by reference to the same parent, *all* the children's NUI must be added to the parent's income to calculate the aggregate hypothetical increase in parental tax, and each child's share of APT is proportional to the ratio of his own NUI to the aggregate of all the children's NUI.[9] This rule has the potential to push the applicable tax rate even higher.

The "parent" whose rates are borrowed for purposes of the kiddie tax is the custodial parent if the parents are not married, and if the parents are married but file separately, the parent with the greater

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4. I.R.C. § 1(g)(2).

5. More exactly, NUI is defined as unearned income which exceeds twice the $500 amount of the standard deduction allowable to taxpayers who are eligible to be claimed as dependents on another taxpayer's return ($650 for 1995 as indexed for inflation), or $1,300. I.R.C. §§ 1(g)(4)(ii) and 63(c)(5)(A).

6. This amount may be increased to the extent that the child has itemized deductions which exceed $650 and are "directly connected" to the production of the unearned income. I.R.C. § 1(g)(4)(A)(ii)(II). This rule will not be further discussed here.

7. I.R.C. § 1(g)(3).

8. *Id.*

9. I.R.C. § 1(g)(3)(B).

taxable income.[10] If the parents file jointly, it is their joint tax which is the point of departure for calculating the child's APT. This is so even if the applicable parent has remarried and files a joint return with a nonparent who was not the source of the child's funds.[11]

If the child's tax would be greater if computed without regard to the kiddie tax (say because the parent has losses which would be offset by the child's gains), the kiddie tax does not apply.[12] If the kiddie tax does apply, the child must file Form 8615 which requires eighteen lines of calculation.[13]

B. The Child's Exemption and Standard Deduction

In addition to enacting the kiddie tax itself, the 1986 TRA made profound changes to the child's personal exemption and standard deduction. Under pre-1987 law, a child who was claimed as a dependent on another's tax return (for a deduction of $1,080) was nevertheless entitled to a full personal exemption (in the amount of $1,080) on his own return. The 1986 TRA raised the personal and dependent exemption amounts to $2,000,[14] but disallowed the $2,000 exemption altogether for a child who was eligible to be claimed as a dependent on another's return (whether he is so claimed or not).[15]

Pre-1987 law allowed the child the equivalent of a full standard deduction (then called zero bracket amount) applicable to single taxpayers with respect to earned income, but no standard deduction at all with respect to unearned income.[16] The 1986 TRA modified former law by increasing the child's standard deduction to the greater of $500[17] or his earned income[18] (up to $3,000).[19] If the child has both an earned and unearned income, the first $500 of the standard deduction is allocated to offset unearned income, and any excess standard deduction is then allocated to offset earned income.[20] Thus, the child is allowed

10. I.R.C. § 1(g)(5).

11. Treas. Reg. § 1.1(i)-1T, A-13 (1988).

12. I.R.C. § 1(g)(1).

13. Unless the parent elects under I.R.C. § 1(g)(7) to report the child's NUI on his own return using Form 8814. *See infra* Part I.C. According to the Paperwork Reduction Act Notice in the Instructions to Form 8615, the estimated average time needed to learn about the law or the form is twelve minutes, and forty-four minutes are needed to complete the form.

14. Indexed for inflation, the amount for 1995 is $2,500.

15. Disallowance of the exemption whether or not the child is claimed on another's return seems unfair; someone should always get the benefit of the exemption.

16. Former I.R.C. § 63(e).

17. The amount for 1995 is $650.

18. I.R.C. § 63(c)(5).

19. The amount for 1995 is $3,800.

20. I.R.C. § 1(g)(4); and Treas. Reg. 1.1(i)-1T, ex. 5 (1988).

to offset at least $500 (ignoring inflation) of unearned income by the standard deduction.

Taking into account both the loss of the child's personal exemption and the increase in the standard deduction, however, the overall effect was to *lower* the income threshold at which the child must file a return and pay taxes from $1,080 to $500 (plus any earned income, up to the allowable limit).

C. The Parent's Election

Halving the child's filing threshold to $500 caused the IRS to estimate in 1987 that the kiddie tax would require the filing of about 3.7 million additional returns.[21] In 1988, the expected flood of new returns (and a chorus of complaints about the complication of using borrowed rates) led Congress to enact the election under I.R.C. § 1(g)(7)[22] which permits parents to include a child's unearned income on their own returns. Compared with filing the kiddie tax return, the election has the obvious advantage of greater convenience, although it, too, requires the filing of the new Form 8814 for each child. On the other hand, the election almost invariably costs more in taxes for two reasons. First, unlike using Form 8615, the election increases the parent's adjusted gross income (AGI), and that in turn may trigger a variety of ceilings, floors, and phaseout provisions which are measured by AGI.[23] Second, the $500 exemption amount and $500 15 percent bracket have not been indexed for inflation, so that the parent's highest bracket is reached after including only $1,000 of the child's unearned income, as opposed to $1,300 (for 1995) using Form 8615.[24]

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21. According to John Ader, Deputy Assistant Commissioner for Taxpayer Service and Returns Processing, as reported in TAX NOTES, Nov. 2, 1987, at 206.

Because children with unearned income above $1,080 were required to file returns under prior law, the increase is presumably due solely to children earning more than $500 but less than $1,080. Income within that spread is subject to a maximum rate of 15% and is not subject to the borrowed rates of the kiddie tax proper.

22. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6006 (1988).

23. For example, the allowable deduction for miscellaneous itemized deductions, medical expenses, and casualty losses is limited to the excess of 2%, 7.5%, and 10% of AGI, respectively, under I.R.C. §§ 67, 213(a) and 165(h)(2)(A)(11); itemized deductions and personal exemptions are phased out for high-income taxpayers in proportion to AGI under I.R.C. §§ 168 and 151(d)(3), and so on.

24. It is unclear whether Congress deliberately intended to exact this price for a convenience by which it benefits fully as much as the taxpayer, or whether it is only a drafting oversight. The difference arises as a technical matter because NUI is defined under I.R.C. § 1(g)(4)(A)(ii) which refers to I.R.C. § 63(c)(5) (exemption amount), which in turn is governed by the indexing provision I.R.C. § 63(c)(4). By contrast, the exemptions for the election under I.R.C. § 1(g)(7)(B) are flat amounts of $500

Congress imposed some arbitrary limitations on the election as well: the election cannot be made unless (1) the child's gross income is *solely* from interest and dividends (including Alaska Permanent Fund dividends),[25] and (2) the child has unearned income over $500 but less than $5,000.[26] It follows from the first limitation that if the child has even one dollar of earned income, the election cannot be made.[27] If the election is convenient, it may be expected that parents will simply disregard this requirement and conceal the existence of the child's earned income.[28]

D. Avoiding the Bite

The simplest way to avoid the bite of the kiddie tax is to make sure that the child has no more than $1,300 of unearned income. The maximum tax saving on that first $1,300 is only about $260 in federal income taxes. The effect of *state* income taxes should not be overlooked, however. Only two of the fifty states follow the federal government and impose a kiddie tax,[29] so the child may still enjoy a substantial saving as compared with allowing current income to be taxed to the parent.

Current income may be avoided until the child reaches age fourteen in a variety of ways, most obviously including investment in growth stock which pays no dividends, municipal bonds, U.S. series EE bonds upon which interest is not taxable until maturity, and so forth. On the other hand, most of these strategies work just as well for the parent, and so given a choice, there is no *income tax* advantage to making such investments in the child's name. If the child already has capital,

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which are not expressly linked to the standard deduction. Thus, the election inevitably costs an extra $22.50 ($650 − $500 = $150 × 15%) plus the excess of the parent's tax on $150 over $22.50 (assuming a parental rate of 39.6%, that would be $36.90).

25. Every resident of Alaska receives a dividend of more than $500 per year, including minor children. The I.R.C. § 1(g)(7) election seems to have been enacted at least in part due to complaints from the Alaska delegation in Congress about the inclusion of such dividends in the sweep of the kiddie tax.

26. I.R.C. §§ 1(g)(7)(i) and (ii), respectively.

27. Apparently it was feared that confusion might result if the child's earned income were subject to withholding under a TIN different from that of the parent. It is not clear why that should be any more confusing than comparing Form 1099s for dividends and interest bearing the child's TIN number, or for that matter Forms 1099 reporting capital gains (which apparently would prevent use of the election).

28. By the age of ten or eleven, most children probably have some earned income from babysitting, shoveling snow, and the like, if not from a regular job such as delivering papers.

29. The two are California and Hawaii, according to Beth Kobliner, *Cut These State and Local Taxes*, MONEY, Jan. 1994, at 82.

however, it may be advisable to revise the investment strategy to avoid current income.

III. Design Defects of the Kiddie Tax

A. Overbroadness

The kiddie tax applies to all the child's unearned income from any source, including sources for whom tax avoidance could not conceivably have been a motive. Income from gifts from grandparents is subject to the kiddie tax, for example, even if the grandparents have marginal tax rates lower than the child or the parents.[30] Also subject to the kiddie tax is income produced by a child's inheritance, life insurance proceeds, or by investment of a compensatory award of damages for personal injuries. The latter rule was upheld under constitutional attack in two cases, *Carlton v. U.S.*[31] and *Butler v. U.S.*,[32] where the taxpayers unsuccessfully relied upon *Hoeper v. Tax Commissioner.*[33] Even income from the child's savings out of his own earnings is included and must be taxed at the marginal rate of the parents.

Taxation of all the child's unearned income (above the first $1,000) at parental rates, regardless of the source of the child's capital is clearly overbroad to the extent that the kiddie tax is justified by the stated purpose of preventing parental assignments of income. The original proposal for a kiddie tax in Treasury I[34] would have applied only to

30. However, grandparents (and parents) may be motivated by the gift or estate tax saving offered by gifts of $10,000 per donee per year under I.R.C. § 2503(b).

31. 789 F. Supp. 746 (N.D. Miss. 1991).

32. 798 F. Supp. 574 (E.D. Mo. 1992).

33. 284 U.S. 206 (1931) (Wisconsin tax statute held unconstitutional as violative of Fifth Amendment substantive due process where statute required aggregation of all family income at progressive rates which resulted in increased tax upon husband who was liable for entire family tax). Both the *Carlton* and *Butler* courts distinguished *Hoeper* on the ground that *Hoeper* involved taxing one person upon the actual *income* of another person, rather than merely by reference to the tax *rate* of another person. It appears that this distinction is incorrect, however. In *Hoeper,* the taxpayer had the option of filing separately and limiting his liability to that part of the (increased) tax on the aggregate family income which was proportional to his own individual income. *See* Ann F. Thomas, *Taxing Women's Lives: Taxation and the Economic Identity of Married Women*, at 24 (1995) (unpublished draft on file with the author). The Wisconsin tax issue in *Hoeper* at bottom involved borrowed rates, and is indistinguishable from the kiddie tax cases. Since the general demise of substantive due process, however, *Hoeper* is probably no longer reliable precedent.

34. THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT: TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, GENERAL EXPLANATION v. 2, at 93 (1984).

income from parental gifts, and all other unearned income would have been separately taxed at the child's rates.[35] Both the House and Senate versions of the kiddie tax followed the Treasury I approach, and would have allowed the child to set up "qualified segregated accounts" for nonparentally sourced unearned income to prevent application of the kiddie tax. In conference committee, however, this selective approach was abandoned due to fear that sourcing rules would create undesirable complexity and would lead to administrative difficulties.[36] Such fears may well have been justified. On the other hand, the burden of proving the child's source of income would be on the child or his representative, and if he were willing to do the necessary recordkeeping, fairness would seem to require allowing income which is untainted by any motive of tax avoidance to be taxed at the child's own rate. This would have been particularly desirable for income from investment of inheritances, tort awards, and the child's own earnings. If the kiddie tax could not be confined to parentally sourced income, it would have been better to abandon the tax altogether.[37]

Where the amounts of income involved are large, taxpayers would probably have been glad to comply with the necessary source accounting rules in order to secure exemption from the surtax. A relatively easy solution to the problem would be to confine the kiddie tax to high-income children alone who enjoy large amounts of unearned income from parental gifts, say $10,000 or more.[38] This would have exempted the vast majority of middle-class children from the tax at an extremely low revenue cost, and imposed the tax only on the relatively wealthy.

If the kiddie tax had been narrowly targeted at high-income children, the administrative problems of distinguishing income from tax-motivated gifts from other unearned income would have been easy to solve. Families in which children have income of over $10,000 per year probably receive professional tax advice in any event, and segrega-

35. Also, the tax would apply only after the child enjoyed a full personal exemption of $2000. *Ibid.*

36. *See* Leo L. Schmolka, *The Kiddie Tax Under the Tax Reform Act of 1986: A Need for Reform While the Ink Is Still Wet*, 11 REV. TAX'N INDIV. 99, n.21 (1987).

37. The ultimate result of the global kiddie tax was that it falls only upon the innocent. *See infra* section II.D.

38. This approach is consistent with the interest-free loan rules, under which there is a quite sensible exception for gift loans under $100,000 in amount. Thus, middle-class parents can loan a child up to $100,000 interest free for college or purchase of a home without becoming subject to tax on imputed interest; and in effect, the rules only apply to the relatively wealthy.

tion of the child's parental gifts in an account separate from the child's other assets would present few problems. Income from other sources, such as inheritances, tort recoveries, gifts from grandparents, income from the child's own earned savings, and so forth could then be readily exempted from the kiddie tax.

B. Complexity

The use of borrowed rates introduces an undesirable degree of complexity and also raises some issues of privacy. Because the child's tax cannot be computed without first completing the (appropriate) parental tax return, the kiddie tax necessarily extends the time required to compute the overall taxes. After completion of the parental return, it may be necessary to recompute it if the parent's election under I.R.C. § 1(g)(7) appears preferable to filing Form 8615. If the parental return requires an extension, so does the child's return. And if the parental return requires later adjustment, so will the child's return. Also, if any one child's return requires amendment or adjustment, this may affect the other children's taxes by changing their allocable amount of APT.

If the parents are separated but not by final written agreement or divorce, the kiddie tax must be computed by reference to the higher-income spouse even if the other spouse has physical custody of the child. This is likely to lead to situations in which sensitive financial information may be required by one spouse from the other which may lead to undesirable friction, inability to complete the tax forms accurately, or both.

Conceptually, the kiddie tax is anything but simple. Children under fourteen are partly separate taxpayers and partly not, as to both rates and liability. I.R.C. § 1(g) vacillates among four different notions of the child-taxpayer:

1. the child is a separate taxpayer as to both rates and liability (over fourteen);
2. the child is a separate taxpayer as to liability but his rates are determined partly by his own income (his standard deduction and earned income);
3. same but his rates are determined partly by his parents' income (and partly by his siblings' income as well), without feedback affecting parental tax rates; and
4. the child is a nontaxpayer whose parents are liable for tax on his unearned income at their rate, with feedback which affects the parental rate (election).

This is not exactly clear thinking, nor is it simple.

C. Inefficiency and Noncompliance

As pointed out above,[39] the IRS estimated that the new rules would swell the tax rolls by an additional 3.7 million child-taxpayers.[40] The Joint Committee estimated the revenue from the kiddie tax would be $60 million in 1987, $195 million in 1988, $226 million in 1989, $249 million in 1990, and $274 million in 1991.[41] For 1988, that meant at most an average tax yield of $52 per new return. That yield probably would not cover the costs of preparing and processing the child's return.[42] Many affected taxpayers who became aware of this absurdity probably exercised self-help and simply ignored the rules. Many others have quietly unmade tax-motivated "gifts" to their children.

The main culprit is, of course, loss of the child's own personal exemption of $2,000. Nearly one-half of the Form 8615s filed reflect AGI of less than $2,000[43] and would not be on the tax rolls at all but for the 1986 reform. Gene Steuerle, who coordinated Treasury I which initiated the kiddie tax, has explained that the repeal of the child's exemption was the result of a last-minute search for revenue in the course of final negotiations over the 1986 TRA, and that nobody was concerned at that late hour with the complexity this would entail.[44]

The error of repealing the child's exemption might have been partially compensated for if the new $500 standard deduction for unearned income

39. *Supra* note 21.

40. This is a peculiar expectation from government reformers who prided themselves on *ridding* the tax rolls of some 6 million low-income taxpayers. *See* STAFF, JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (1987) (the "BLUE BOOK") at 13.

41. H.R. REP. No. 99-841, 99th Cong., 2d Sess., II-881 (1986).

42. The average cost to the IRS of processing a return is $21.50. *See* Jeffrey A. Dubin, et al., *The Changing Face of Tax Enforcement*, 43 TAX LAWYER at 893, 895 (Table 1) (1990). To that must be added the taxpayer's cost of filing. *See* Timothy Baetz, *The Indefensible Kiddie Tax*, TRUSTS & ESTATES April 19, at 27, 28. Baetz observes that if a dime must be spent on taxpayer compliance and IRS enforcement in order to collect a nickel of revenue, the game is not worth the candle.

43. For 1991, 131,364 returns out of a total of 287,777 with Form 8615 showed AGI under $2,000. DEPARTMENT OF THE TREASURY, STATISTICS OF INCOME BULLETIN, at 76, Table 2 (Summer 1995). For 1987, the figure was 229,117 out of a total 464,691 filed. DEPARTMENT OF THE TREASURY, STATISTICS OF INCOME BULLETIN at 28, Table 2 (Summer 1991).

44. Gene Steuerle, *How Taxes Become Complicated: The Case of Taxing Children*, TAX NOTES 1519-20 at 45 (12) (Dec. 18, 1989). It is interesting to note that the lawmakers involved are apparently not anxious to claim any credit for introducing the kiddie tax. MONEY magazine sought comment from eight of the congressional leaders who enacted it, but no one wanted to be quoted. "Tax Policy always takes in some people it wasn't intended to," observed an aide to Republican Senator Bob Packwood. *See* Andrea Rock, *The Kiddie Tax Nips the Wrong Family*, MONEY, Feb. 1988, at 63.

had been allowed *in addition to* (rather than *instead of*) an equal standard deduction for earned income. Professor Thuronyi, who was one of the main architects of the kiddie tax, has called this problem the "earned income trap."[45] The child's standard deduction is the greater of the earned income or $650, and that can produce bizarre results if the child has both earned and unearned income. For example, if a child has $649 of earned income, a return will be required if the child has even five dollars of unearned income.[46] It makes little sense to tax such a child, as Professor Thuronyi points out, because children with far greater unearned income (up to $650) are not taxed.[47] It also makes little sense to tax a child with $650 of unearned income who has ten dollars of earnings, but this too follows from the greater-of rule for the standard deduction and from the loss of the child's personal exemption. As a practical matter, unearned income is almost inevitably picked up through information reporting on Form 1099s, whereas small amounts of *earned* income from miscellaneous chores are very unlikely to be reported or withheld upon and are probably routinely ignored by taxpayers.

Even the unearned income of children is probably misreported on a large scale because Form 1040 does not ask the age or date of birth of the taxpayer or his dependents, nor is such information shown on Form 1099 for interest or dividends. Thus, even if a parent is aware that his child should file a Form 8615 for unearned income, the temptation is probably great to have the child file as if age fourteen or older instead.

IV. Why Have a Kiddie Tax At All?

In a system of progressive taxation, aggregate family income taxes can be reduced by deflecting income from high-bracket taxpayers to their lower-bracket family members. In the United States, as elsewhere in the world, the history of family taxation is largely a tale of attempts to secure, and counter-attempts to forestall, just such tax advantages. The steeper the progressivity of the rates, the more there is at stake in such issues, and the flatter the rates, the less such issues should raise any concern. For that reason it seems very odd that the framers of the 1986 TRA should have thought of enacting a revolutionary new kiddie tax in order to protect the integrity of the progressive tax system at the very moment when tax reform was principally intended to, and

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45. Victor Thuronyi, *The Kiddie Tax: A Reply to Professor Schmolka*, 43 TAX L. REV. 589, 602 (1988).

46. The tax will fall on four dollars of *earned* income at the 15% rate.

47. Professor Thuronyi sensibly recommends that the standard deduction be revised to offset $500 of unearned income *plus* all unearned income up to a total of $3,000. Thuronyi, *supra* note 45, at 602.

did, *reduce* progressivity by lowering the maximum tax rate from 50 percent to 28 percent.[48]

The kiddie tax is all the more surprising when it is remembered that, as part of the same 1986 TRA, Congress repealed both the two-earner deduction (which partially mitigated the marriage penalty) and income-averaging with the explanation that the new flattened rate structure made the need for relief provisions less acute.[49] The tax advantage (and potential revenue loss) from assignments of income to children was similarly reduced for exactly the same reason. Why should a highly complex new provision be added to combat a "problem" which (if it existed at all) was diminished in precisely the same way by the simultaneous rate changes?

To illustrate, consider that at 1988 rates, the maximum amount which could be saved by diverting income to a child (absent the kiddie tax) was about $2,400 per year.[50] In order to obtain this maximum tax saving, the child would have needed taxable income of $17,850 (and therefore gross income of $18,850) for the taxable year.[51] To earn such an amount of income from investments at, say 8 percent, the child would require assets of about $240,000. The net saving is an additional return of only 1 percent, which does not seem great enough to induce massive gifts of capital.[52] Moreover, there may be gift tax consequences which could well make such a gift a net loss after taxes.

At 1988 tax rates it is all but inconceivable that anyone's sole motive for gifts to children could be a free ride up the brackets.[53] Under Trea-

48. Though with a bubble under former I.R.C. § 1(g) which created a 33% bracket by means of phasing out personal exemptions.

49. BLUE BOOK, *supra* note 40, at 14-19.

50. That amount is the difference between income which would be taxed to the child at the 15% rate rather than the parent's 28%. The child's first $500 of income is taxfree by reason of his standard deduction, and next $500 of unearned income is taxed at the 15% rate. The effect of the "bubble" is ignored.

51. Above such amounts of income, the child is himself in the 28% bracket and nothing further is gained by income-shifting.

52. A parent can do much better by keeping the money and purchasing municipal bonds rather than Treasuries.

53. Except, possibly, for capital gains, on which the 1986 TRA *increased* the maximum rate from 20% to 28%. Deflection of capital gains can result in a much greater tax saving relative to the size of the gift, because gifts of appreciated property with a zero basis are taxable in full at the lower rate. There would still be the same limit to the tax saving per child, but the limit would be reached more quickly. Deterring gifts of appreciated property seems not to have been one of Congress' concerns in enacting the kiddie tax. Nor should it have been.

The 1986 increase in capital gains tax rates from 20% to 28% was and remains a highly controversial issue. Although the general problem is outside the scope of this article, it seems worth pointing out that many countries which do tax capital gains also provide limited relief for small amounts. Canada, France, and the U.K. all provide sury I's proposed brackets of 15, 25, and 35 percent, the maximum savings from a bracket ride would have been $6,160 (compared to $12,560 under the 14 percent-bracket system in effect until 1986).[54] Perhaps Congress simply did not realize that when the final compromise set the maximum rate at 28 percent,[55] the proposal no longer made any sense.[56]

On the other hand, it might be argued that flattening the rate structure required broadening the tax base and eliminating loopholes both to fund the rate reductions and as a matter of principle. The trivial amount of revenue predicted by the government's own estimate seems to negate the first reason. As for the question of principle, it is very doubtful whether the tax saving from gifts to children under former law was a loophole.

A. Outright Gifts are Not an Assignment of Income

To regard as a loophole the paradigm case for which the kiddie tax was designed, viz., parental gifts of capital to children, seems contrary to long-standing principles of tax law. It has always been the law that assignments of income are disregarded only where the donor retains some beneficial interest in or control over the transferred corpus. If the "tree" is transferred outright, and the donor retains no reversionary interest or rights to enjoy or dispose of the income directly or indirectly, the transfer shifts the tax on the "fruit" to the donee.[57]

The kiddie tax is also contrary to the long-standing principle that the individual is the taxpayer, rather than the family.[58] Why this sudden abandonment of two fundamental principles of law? The committee

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such relief and simply exempt from tax a limited grace amount of gains. The possibility of avoiding the first $2,500 of U.S. tax on capital gains per child per year via bona fide gifts should perhaps be tolerated as a useful safety valve rather than a loophole.

54. *See* Baetz, *supra* note 42, at 27, 28. Treasury I did not recommend disallowance of the child's $2,000 exemption, but assumed the child would not be entitled to any standard deduction, as was the case under 1985 law.

55. Apart from the artfully disguised "bubble" under I.R.C. § 1(g) which made the kiddie tax (along with the tax on all other income) more onerous for the middle class than for the wealthy.

56. If indeed it ever did. Perhaps Congress foresaw the possibility of raising overall rates in the future, and introduced the kiddie tax in anticipation.

57. This is still true for transfers to a spouse, which constituted the main battlefield for litigation over such issues before 1948 (when income-splitting was introduced for joint returns), and for transfers to a child over 13 years of age.

58. Although over 95% of married couples file jointly, which results in a *de facto* system of taxing married couples as a unit, the joint return is nevertheless in principle elective. Absent the election, the spouses are taxed as individuals, albeit at rates which are normally unfavorable. The unfavorable rates are due only to marital status, and unlike the kiddie tax, they are not directly determined by reference to the taxable

reports and commentaries do not challenge the correctness of these principles themselves. Instead, the assumptions which seem to underlie the kiddie tax are (1) that transfers to children are always a sham because the parents retain control over the income, and by implication (2) that there are no good nontax reasons for making gifts of capital to children, so that a presumption of tax avoidance motive is justified. Both assumptions seem very dubious.

B. Gifts to Children Should Not Be Treated as a Sham

Treasury I justified its recommendation of a kiddie tax by the need to combat the perceived abuse of parents transferring property to children without relinquishing control over the funds, thus enabling the parents both to use the income for the living expenses of the children and to reduce taxes:

> . . . [U]nder the Uniform Gifts to Minors Act (UGMA), a person may give [income producing] property to a custodian for the child (who generally may be the donor). As a result of the gift, *legal* title to the property is vested indefeasibly in the child. During the child's minority, however, the custodian has the power to sell and reinvest the property; to pay over amounts for the support, maintenance, and benefit of the minor; or to accumulate income in the custodian's discretion. . . .
>
> A family whose income consists largely of wages earned by one or both parents pays tax on that income at the marginal rate of the parents. *Even though the income is used in part for the living expenses of the children,* parents may not allocate a portion of their salary to their children and have it taxed at the children's lower rates. . . . Parents with larger amounts of capital, however, can afford to transfer some of it to the children, thereby shifting the income to lower tax brackets.[59]

Treasury I was incorrect as to both assertions. Under the UGMA, the donor-custodian may *not* use income from custodial funds for the

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income of another family member. The kiddie tax is not elective (except for choice of evils between Forms 8615 and 8814).

Note also that if the child's tax would be greater calculated separately rather than by means of the parents' rate, the higher tax must be paid. I.R.C. § 1(g)(1). This, too, is contrary to the rules for joint returns, under which the spouses are free to file separately in the rare instances where that leads to a lower tax. The "greater of" rule of I.R.C. § 1(g)(1) seems completely unprincipled: the child is a separate taxpayer if, and only if, the government would profit.

A general discussion of the individual versus the family as the taxable unit is beyond the scope of this article. It should be noted, however, that the worldwide trend of other income tax systems has been almost uniformly in the opposite direction of dismantling complex mechanisms for aggregating family income in favor of taxing individuals without regard to marital or family status. In this respect, the kiddie tax is a step backwards into a past which has been rejected by nearly all other countries.

59. GENERAL EXPLANATION, *supra* note 34, at 92-93. [italics added].

children's living expenses, and if he does so anyway in violation of the UGMA, it will *not* shift the tax to the children.[60] Taking the first issue first, it is probably true that in the usual case of a transfer under the UGMA, the donor parent will be the custodian responsible for the child's investment decisions.[61] Nonetheless, such a transfer is irrevocable under the UGMA, and the parent custodian is under a fiduciary duty to manage the custodial funds solely for the benefit of the minor. The income may not be spent for the donor's benefit. Thus, if the parent continues to enjoy the child's income as if the transfer had never taken place, it is contrary to law and may be actionable wrongdoing.[62] I know of no evidence for assuming widespread lawlessness of this kind,[63] and the legislative history of the kiddie tax provides none.

It is true that UGMA § 4(b) permits the custodian to pay over amounts for the support of the minor. However, the case law is very clear that if the custodian is liable for the support of the minor, he may not use the custodial funds for the benefit of the minor if it serves to discharge his own obligation of support and if the custodian has sufficient means to satisfy his obligation out of his own property.[64] This rule already prohibits the alleged abuse which Treasury I offered as the rationale for the kiddie tax, and also undercuts its argument on grounds of horizontal equity: neither the wage-earner nor the owner of capital can split income in this way.[65]

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60. *See infra* section III.C.

61. This will bring the custodial funds into the donor's estate however, which may be an error for purposes of planning for the estate tax.

62. If the transfer is not pursuant to U.G.M.A. or similarly irrevocable, it was always open to the IRS to challenge the bona fides of the transfer.

63. Except for staffers on Capitol Hill. In 1989, I spoke with a staff member on the Joint Committee who had participated in the discussions on the kiddie tax. He told me that before 1987, he personally put money in his children's names and then spent the income for household expenses, and furthermore that all his friends did the same thing. When I explained to him that this did not shift the tax under pre-1987 law, he expressed surprise.

64. *See, e.g.*, Sutliffe v. Sutliffe, 489 A.2d 764 (1985), *aff'd and remanded* on other grounds 528 A.2d 1318 (1987), interpreting U.G.M.A. § 4(b) (divorced father may not use custodial funds to pay child support and other expenses of children because to do so would benefit father, rather than children, by discharging his obligation of support).

65. A frequently advanced argument in favor of a kiddie tax is that without it, parents with capital can achieve tax savings which are not available to other taxpayers who have nothing to transfer, or nobody to transfer it to. That is true. It is just as true, however, that taxpayers who lack capital cannot make large charitable contributions, deduct capital losses, buy municipal bonds, make interest-free loans, or earn interest of any kind. Similarly, taxpayers without children (or employment) cannot enjoy the child care credit or exemptions for dependents.

The horizontal equity argument assumes what it sets out to prove. Revenue from capital is (usually) gross income, just as wages and salaries are gross income. From

As a practical matter, however, it may appear that there is nobody to complain about such misuse of the child's funds and that the prohibition against self-dealing is toothless. This is probably true as long as divorce does not bring an adverse party into the picture. If the parents divorce, the donor's ex-spouse may have an incentive to enforce the donor's legal obligations, and the donor will no longer have the de facto power to unmake his "irrevocable" gifts. In addition, the donor parent will probably lose any freedom he might have counted on as custodian of the child's account to use the child's funds directly or indirectly for his own benefit, because the other spouse will have an adverse interest in protecting the child's money. Such a scenario seems especially likely where the nondonor spouse is the wife and has custody of the child. She would have an incentive to monitor the husband's performance as custodian of the child's funds, and if necessary to bring an action on the child's behalf for an accounting, or a transfer of custodianship.[66] The custodian may be called to an accounting by the child at age fourteen, and must surrender the principal when the child reaches eighteen, or twenty-one at the latest.

Divorce also brings a significant risk that the assets of the child will not be taken into account in fixing the support obligation of the noncustodial parent.[67]

Thus, the proposition that parents should be taxed on the income from gifts to minors cannot be justified by the retention-of-control argument offered by Treasury I. Control in the limited and nonbeneficial sense applicable to the duties of a trustee or other fiduciary has never been sufficient to shift the incidence of tax from the beneficial owner. To shift the tax, the powerholder's control must provide him with an actual or potential economic benefit, and this is not the case for legal

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that it most certainly does not follow that taxpayers with equal amounts of gross income are similarly situated. Taxpayers who possess significant amounts of capital are not similarly situated in any common-sense way to wage earners without savings. As a policy matter, it may be that returns from capital should be taxed either more lightly or more heavily than earned income, and the income tax has at various times reflected both possibilities. The debate over such questions is largely concerned with progressivity, or vertical equity. Horizontal equity should be viewed as requiring only that similarly sourced income be taxed similarly.

66. This is in fact the typical scenario in which the reported litigation has occurred. See Sutliffe, *supra* note 64, and cases cited therein.

67. Under New York law, for example, a judge may not depart from the statutory minimum child support schedules unless he provides a written explanation of the factors taken into account in his decision. The statute does list the child's own assets as such a factor which might be taken into account, but it is purely optional. Also, as will be pointed out below, if the child's income is actually used for the child's own support, this will raise the specter of shifting the tax on such income to the parent(s) having legal responsibility for the child's support.

gifts to minors. Proponents of the kiddie tax have confused these two senses of "control" to make their case.[68]

C. Adequacy of Prior Law to Combat Abuse

If there were in fact serious revenue losses before 1987 from assignments of income through gifts to minors, it is puzzling that the IRS seems to have taken no steps to stem them by enforcing rules which were in existence long before the kiddie tax. Income from a minor's custodial account is taxable to the person obligated for the minor's support to the extent it is used to satisfy the obligation. Revenue Ruling 56-484[69] held that income from property transferred under the Model Gifts of Securities to Minors Act which is used to discharge a legal obligation of any person to support a minor is taxable to such person to the extent so used, but is otherwise taxable to the minor donee. That ruling was generalized by Revenue Ruling 59-357[70] to apply to the UGMA as well. A similar rule under IRC § 677(b) has long applied to trusts. The fact that these rules have apparently never been vigorously enforced casts doubt on the seriousness of the perceived problem.[71] It is also odd that neither Treasury I nor the legislative history of the kiddie tax even mentions these support rules, much less discusses any enforcement difficulty in them.[72]

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68. *See, for example,* Thuronyi, *supra* note 45 at n.5, ". . . it is my recollection that the parental control argument was the primary one adopted by those in charge and emphasized in discussions with members of Congress." *See also* Martin J. McMahon, Jr., *Expanding the Taxable Unit: The Aggregation of the Income of Children and Parents*, 56 N.Y.U. L. REV. 60, 107-109, 144 (1981) (arguing that the strongest case for aggregation is where parents have transferred assets because they retain control or deliberately gave up control, and that there is good reason for aggregation of children's income from other sources either on control grounds, or where control is lacking, on grounds of indirect benefit). Professor McMahon considers third-party payments for the benefit of a child from an independent trust as an "indirect benefit" justifying taxation to the parent on the ground that "he is relieved of a social or moral obligation to provide for the needs of his child." *Id.* at 108.

The argument proves too much. For example, if a grandparent has superfluous income which she adds to her substantial savings which the parent reasonably expects to inherit, the parent is relieved of a "social and moral obligation" to provide for the grandparent's needs, and in addition, the parent may benefit by feeling safe to spend on personal consumption rather than saving for his own retirement or the future needs of his own children.

69. 1956-2 C.B. 23.

70. 1959-2 C.B. 212.

71. Additional doubt is warranted by Treasury's own estimates of the revenue to be gained from the kiddie tax, *see supra* section II.C., and from the meager benefits obtainable under post-1986 rates, *see supra* section III.

72. Interestingly, these rulings have not been revoked and appear to remain good law. If the child's unearned income is spent for his support, how do the rulings intersect with the kiddie tax? Can the rule requiring application of the higher-income parent's rates to the child's income be circumvented by having the lower-income parent report the income as the support obligor?

Some difficulty of enforcement might arise from the fact that provision of *luxuries* out of the child's income over and above ordinary support is in principle not taxable to the support obligor. Aggressive tax planners had long taken advantage of this exception by limiting use of the child's income to the purchase of such nonessentials.[73] On the other hand, there is considerable confusion as to the precise extent of the obligation to support under the law of any state, and to the extent the rules are ascertainable, they vary considerably from state to state. There is very little law in any state as to the level of required support for children within a unified family,[74] as opposed to the obligation of a noncustodial parent.[75]

It would be relatively simple for Congress to preempt state law by enacting a uniform rule for tax purposes that any amount of a minor's unearned income which is spent for his own benefit is taxable to the support obligor.[76] In any case, the ambiguity in current law does not explain generally lax enforcement. If income reported by a child is assessed to the parent, the burden of proof is on the parent to show that the income was not used to satisfy his support obligation. Some well-publicized audits would surely have had a deterrent effect upon abusers. If the old rules had been enforced, the abuse problem would have disappeared, and income-splitting with children would probably have been confined chiefly to income which is accumulated, viz., to socially desirable savings. This would have done no violence to any principle of current law, and would have obviated any need for the complex and onerous new tax. In addition, it would have steered taxpayers in the desirable direction of increasing savings.

If administrative measures failed to curb abuse, Congress should have considered enacting a requirement that unearned income of a dependent minor must be accumulated in the minor's account as a condition of taxability to the child, on the analogy of retirement savings. This would have solved any remaining enforcement problems due to ambiguity of the support rules by imposing an irrebuttable presumption

73. *See, e.g.*, RICHARD A. WESTIN & ALAN H. NEFF, TAX, ATTACKS AND COUNTERATTACKS 71 (1983).

74. It is unclear in most states whether a wife or child has a right to enforce support from the husband while they are still living together beyond the minimum necessary to keep body and soul together. A wealthy husband can keep his family in rags while the family is together, even though the wife and children would receive significant benefits upon divorce. *See* Mary Moers Wenig, *The Marital Property Law of Connecticut*, 1990 WISC. L. REV. 807, 852 (1990).

75. *See* Note, *Federal Tax Aspects of the Obligation to Support*, 74 HARV. L. REV. 1191, 1203-1206 (1961).

76. *See* Stanley Nitzburg, *The Obligation of Support: A Proposed Federal Standard*, 23 TAX L. REV. 93 (1967).

that any income currently spent was for support and so taxable to the support obligor.[77] Such a rule would have narrowly targeted the tax penalty to abuses alone.

D. Retroactivity: The Tax Falls Only on the Innocent

If potential abusers who made spurious gifts solely for the purpose of tax avoidance are deterred by the kiddie tax from making gifts, the new tax will fall solely upon the honest taxpayers who made gifts for socially desirable reasons, and upon children whose assets came from non-parental sources. Abusers will not be subject to the tax at all. This perverse result is aggravated by the fact that the tax has a retroactive effect. Gifts made before 1987 which were legitimately motivated and which could not be revoked are inescapably subject to the kiddie tax. Specious gifts for abusive purposes have probably been quietly unmade, and may escape the surcharge if the parent invests for tax-free income. Indeed, it appears that the aim of the kiddie tax was not to collect revenue, but simply to discourage gifts to minors.[78]

E. Should Gifts to Children be Discouraged?

In the average middle-class family, it seems probable that the child's savings are prudently husbanded for the future, and ultimately will be spent on the child's own college education or the down payment for a home of his own. It may be that if the child had no savings, the parent would have provided funds for these purposes out of his own savings instead. If so, the argument goes, the tax saving from unnecessary gifts to children before they are grown constitutes an abuse. Perhaps so, but if that is an abuse, let us by all means have as much abuse as possible. Savings for such purposes obviously should be encouraged, and if a modest tax advantage provides some incentive to increased saving of this kind, it is good tax policy.

There are good reasons for thinking gifts to children do in fact increase savings. It is notoriously difficult for most people to save money,

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77. An exception should be made for special medical or educational expenses of the child related to any disability in order to protect minors who pay for special care with the income from tort awards.

78. *See* Thuronyi, *supra* note 45, who wrote in defense of the tax he devised:

> The tax is structured in such a way that parents derive no tax savings and are subject to considerable hassles if the unearned income of a child exceeds $1,000. It is reasonable to suppose that, where possible, parents will structure their affairs so as to avoid this situation. This is easily done. *Parents who have placed [wealth] in their child's name will simply cease doing so . . .*

43 TAX L. REV. 589, 598 (1988).

and once saved, there are numberless temptations to spend it again. To the extent gifts to children put savings beyond the reach of such temptation, as they in fact do under the UGMA, it seems likely that overall savings will be increased. A parent might raid the child's piggy-bank for change to pay the delivery man, but he is unlikely to violate the child's custodial account for an impulse purchase of a car or boat; and if he does, he may incur an enforceable obligation to make it good again.

Also, responsible parents will ordinarily invest the child's savings very conservatively, typically in bank accounts, CDs or savings bonds. If the parent loses his own money in business or risky ventures, the child's savings are preserved. For many middle-class people, gifts to children are probably viewed as a kind of insurance that the child will have the money he needs for his own future no matter what may happen to the parents' assets. That is probably the foremost reason parents (and grandparents) make such gifts to children.[79]

There are also educational reasons for making gifts to children. There is no better way to teach a child the value of savings than to provide some for him, explain how money grows at interest, predict the amounts which will be available in the future and suggest the uses to which they may be put if only the savings are never touched. Many parents do exactly that and inform their children that in addition to the toys which will soon be forgotten, birthday gifts of cash have been added to their savings accounts. Many parents also encourage children to make their own additions to savings.

The kiddie tax penalizes all this, but somewhat surprisingly, it may have unintentionally done middle-class taxpayers a great boon in the process. For taxpayers who are not so wealthy as to be disqualified for need-based scholarships and other financial aid for higher education, it is far more advantageous to have savings in the hands of the parents than the student. Colleges (and the government) use a formula to determine "need" under which the student is expected to spend 35 percent of his savings each year for college, but parents are expected to use only 5.65 percent of their savings annually.[80] Those who saved in their children's names are severely penalized, and those who saved in their

79. The Form 8814 election provides an explicit mechanism for parents to pay the kiddie tax which they probably always paid anyway (though at a lower rate). Most parents whose motive in making gifts was to provide savings for the child probably did not withdraw funds from the child's custodial account in order to pay the kiddie tax, but instead simply made an additional gift to the child by paying the tax themselves.

80. WALL ST. J., Sept. 26, 1995, at C1.

own name as a result of the 1986 TRA were benefitted. It is an ill wind that blows nobody good.

V. Conclusion

The kiddie tax should be repealed. The justifications originally offered for its enactment were unpersuasive. There was probably never any loophole to be closed in the first place; the new tax is overbroad even if there did exist some minor loophole; the tax is a deterrent to savings; and finally it is complicated and expensive to administer considering the trivial amount of revenue that it generates.