WELLS FARGO Wealth & Investment Management

# Tax rules for children

The IRS requires all individuals, regardless of their age, to file an income tax return when their income meets minimum thresholds. This requirement extends to your children.

Each year, you collect information about your income and deductions to prepare your income tax return. Do you do the same for your child? Like you, your child may be required to file an income tax return if he or she receives earned and/or unearned income during the year. The amount and source of income, as well as whether you claim your child as a dependent on your own tax return, determines the filing requirements the IRS has imposed. You also need to be aware of the special rules for determining what tax rate applies to a child's income.

When you are no longer able to claim your child as a dependent, he or she will determine his or her filing requirement just as most taxpayers do. However, if you claim your child as a dependent on your tax return, you must review the child's amount of earned income and unearned income to determine any filing requirement.

## Child's earned income

The IRS treats dependent children differently than other taxpayers, depending on their income's source. A dependent child who has only wages or compensation must file a return if their earned income is more than $13,850 (in 2023). Earned income includes wages, salaries, and other amounts your child receives as a result of providing services to an employer, even if only through part-time employment. Earned income also includes taxable scholarships and fellowship grants.

## Child's unearned income

A dependent child must file a return if his or her unearned income is more than $1,250 in 2023. Unearned income includes interest, dividends, capital gains, and other investment-type income (rents, royalties, etc.). In general, a child would receive unearned income if he or she has an account in his or her name or has any type of custodial account. All taxable income generated from these accounts is reported to the IRS and to the account custodian on an IRS Form 1099 with the child's tax identification number. It is the custodian's responsibility to deliver any tax documents (1099s) to the individual responsible for determining whether a tax return must be filed.

## Combining both earned and unearned income

A dependent child with both earned and unearned income must file a tax return if any one of the following conditions applies:

- Earned income is greater than $13,850
- Unearned income is greater than $1,250
- Earned income plus unearned income is more than the greater of $1,250 or earned income plus $400 (up to $13,850)

Let's take a look at this example:

| | |
|---|---|
| Child's earned income | $2,900 |
| Child's unearned income | $ 500 |
| **Child's total income** | **$3,400** |
| **Earned income plus $400** | **$3,300** |

The dependent child must file an income tax return because the total income ($3,400) is greater than the earned income plus $400 ($3,300).

## Filing a return even if not required

Even if your child does not meet the minimum filing requirements, it still may be beneficial to file a return. Your child may be eligible for a tax refund for taxes withheld during the year, or he or she might qualify for income tax credits. Your child may also need to file a state income tax return. Discuss the situation with your tax advisor, who can help you determine if your child should file a federal or state return.

## Responsibility for child's return

In general, a child is responsible for filing his or her return and paying the tax due. However, if a child is unable to file the return, the parent or guardian must file a return on the child's behalf. If the child is not able to sign the return, the parent or guardian must sign the child's name followed by the words "By (signature), parent (or guardian) for minor child."

There are two options for calculating and reporting your child's taxes. A child may file his or her own federal income tax return and attach IRS Form 8615 to calculate the tax due. The other option, if certain conditions are met, is to report the child's income on the parent's federal income tax return. The parent would attach IRS Form 8814.*

**Note:** Depending on which filing option is selected to report the child's income and whether modified adjusted gross income thresholds are met, the unearned income may be subject to the Net Investment Income tax (3.8% Medicare surtax).*

Parents should also know that the child's investment income and characterization must remain separate from the parents' investment income. That means that investment losses a child incurs cannot be used to offset the parents' realized gains and parents' losses cannot offset the child's realized gains.

*Clients should check with their tax advisors to determine the method to use for filing.

**To better understand the rules' implications, let's look at this example***

| | |
|---|---|
| Child's investment income | $3,200 |
| Less standard deduction | ($1,250) |
| **Taxable income** | **$1,950** |
| Second $1,250 taxed at child's rate (10%) | $125 |
| Amount in excess of $2,500 taxed at parent's rates ($700 x 35%) | $245 |
| **Total tax liability** | **$370** |

* Example assumes all unearned income is ordinary income. A different calculation is required where the child has both earned and unearned income. This is a hypothetical illustration which may differ from your situation. You should discuss your circumstances with your tax advisor.

## Understanding the "kiddie tax" rules

If your child must file an income tax return, you also need to consider another set of rules, commonly referred to as the "kiddie tax" rules, in determining the tax amount owed. The IRS designed these rules to limit parents' ability to shift income-producing assets to their children, who are likely in a lower tax bracket. The kiddie tax applies only to unearned income. Earned income, or compensation, is taxed at the child's ordinary income tax rate.

The kiddie tax rules apply to qualifying children when:

- The child is required to file a return
- The child does not file a joint return for the tax year
- Either parent is alive at the end of the year
- The child is one of the following at the end of the tax year:
  - Under 18 years of age
  - Under the age of 19 and his or her earned income does not exceed half of the annual expenses for the child's support
  - Under 24, a full-time student, and his or her earned income does not exceed half of the annual expenses for the child's support

Children pay tax at their own income tax rate on unearned income they receive up to $2,500 (in 2023). Assuming there is no earned income, the first $1,250 of income is offset by the child's standard deduction. The second $1,250 is taxed at the child's rate. Under the kiddie tax rules, the child's tax rate will be 10% for ordinary income and 0% for long term capital gains or qualified dividends. All unearned income received above $2,500 is taxed at the parent's marginal rates if the parent's rate is higher than the child's rate. (This rule applies even if the parent is not the custodian on the account.) The parent's rate could be as high as 37% compared to the child's 10% rate on ordinary income.

Even a relatively small amount of income in your child's name can trigger a number of additional complex tax rules. That's why it's important to share information regarding your child's income with your tax advisor just as you do your own information.

## Talk to a Wells Fargo Professional

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