U.S. SENATE COMMITTEE ON

Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

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Background on the Tax Rate Changes for Teenagers
from Chairman Grassley's Finance Committee Staff
Tuesday, May 23, 2006

A May 21, 2006, story in The New York Times, "Despite Pledge, Taxes Increase for Teenagers," missed the entire point of the newly enacted change on the taxation of teenagers' unearned income and is factually wrong on several fronts. The article leads with, "The $69 billion tax cut bill that President Bush signed this week tripled tax rates for teenagers with college savings funds, despite Mr. Bush's 1999 pledge to veto any tax increase." A question-and-answer format on the "kiddie tax" change in the *Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)* follows.

Q. Are the Republicans in Congress and the President tripling the taxation on teenagers' college savings funds?

A. No. The Republicans in Congress and the President have shut down a form of tax avoidance for wealthy individuals. Democrats trying to make political hay of this change should remember that Senator Conrad himself proposed it in his substitute to the Republican tax relief bill. His substitute received the support of almost all Democratic senators (please see below).

The new tax law does not change any tax rates on money in a savings account. A 15-year-old will still be able to mow the lawn or work as a summer lifeguard and save money in his bank account with the same tax rates on earned income as before. The tax rates on a child's earned income are lower than on an adult's earned income, and those rates have not changed. Funds placed in Section 529 college tuition savings plans are not subject to federal taxation. The new tax law does not change this. College savings in 529 programs remain untaxed. The same is true for the other tax-free college savings vehicle, Coverdell education savings accounts.

Q. What changes does the newly enacted tax bill make?

In 1986, Congress enacted the "kiddie tax" as a response to parental abuse of tax rates. Some parents were transferring large amounts of unearned income, such as dividend and capital gains proceeds, to their children's accounts to ensure taxation at the children's lower tax rates. Congress acted to shut down this abuse for children under age 14. Congress did not apply the change to children ages 14 to under 18. The newly enacted tax law generally applies the 1986 changes to children ages 14 to under 18.

The distinction between unearned income and earned income is important. Unearned income is interest, dividends, capital gains, or rents. Earned income is wages, tips, and salaries.

Prior to the new tax law, children under the age of 14 who had unearned income (such as dividends but NOT salaries) of more than $1,700 (for 2006) in general have been required to file a return for the year. Now, the same requirement applies to children ages 14 to under 18.

The new law generally taxes unearned income at the parents' rate on only the unearned income over $1,700. Unearned income below $1,700 is taxed at the child's rate. Earned income of a child is taxed at the child's rate. Example: A 16-year-old child with $10,000 in savings and a 5 percent return would have unearned income of $500 and would NOT be subject to this change.

Another example: A 16-year-old child with $30,000 in savings and a 5 percent return would have unearned income of $1,500 and would NOT be subject to this change. That same 16-year-old's earned income (earned lifeguarding or mowing lawns) would be taxed at the child's rate, NOT the parents' rate. A 16-year-old with $2,000 in unearned income and $5,000 in earned income would have the $5,000 in earned income taxed at the child's rate. In addition, $300 of the $2,000 of unearned income generally would be subject to tax at the parents' rate.

Q. Why is this change necessary?

A. The nonpartisan, bicameral Joint Committee on Taxation (JCT) identified income-transferring to children to shield investment income from taxation as a major tax compliance problem. JCT in its report, "Options to Improve Tax Compliance and Reform Tax Expenditures" (JCS-02-05), January 27, 2005, stated:

"The 'kiddie tax' was enacted to restrict the practice of high-income individuals transferring income-producing property to their children so that the income would be taxed at lower rates. This rationale for applying the kiddie tax rules to children under 14 also applies to older children who have not yet attained the age of majority."

The JCT report was in response to a bipartisan request by Chairman Grassley and Senator Baucus to present options to improve tax compliance and reform tax expenditures.

The classic abuse situation would be: A very wealthy family – taxed at the highest rate – transfers $100,000 in bonds to Child X who is 15. Prior to the new tax law, the bonds would have been taxed at the child's rate and not the parents' rate. This reform ends this income shifting.

Q. How many children have enough unearned income to be affected by this reform?

A. The vast majority of children do not have sufficient unearned income to be affected by these changes. For example, for children under 18, JCT estimates that of the 3.27 million children who have unearned income, approximately 2.8 million have unearned income of less than $1,000 – significantly below the $1,700 threshold. An overwhelming number of children who have unearned income above $1,700 received it via transfers from affluent relatives.

Republicans included this reform as part of an overall bill that on net reduced taxes by approximately $70 billion. And Republicans have enacted generous reforms to help Americans save money for their children's college education. The 2001 tax relief law included eight education provisions, including the college tuition deduction at a cost of $9.9 billion over three years.

Q. Why does The New York Times portray this change as a tax increase on teens' college savings plans?

A. That's unknown to us. A May 12, 1990, New York Times story made clear the effects of the "kiddie tax": "With summer approaching, many students would like to find summer jobs. Some parents, on the other hand, being vaguely aware of the 'kiddie tax,' are concerned about the effect that might have on the family's finances. Not to worry, financial experts say. A summer job can bring many benefits, and the kiddie tax applies only to unearned income."

Following are:

(1) the vote record for the Conrad substitute amendment containing the "kiddie tax" change
(2) May 21, 2006, New York Times story
(3) May 12, 1990, New York Times story

S.AMDT.2729
Amends: 1. H.R.4297 , S.AMDT.2707
Sponsor: Sen Conrad, Kent [ND] (submitted 2/2/2006) (proposed 2/2/2006)

AMENDMENT PURPOSE:
To provide revenue provisions.

TEXT OF AMENDMENT AS SUBMITTED: CR S666-677

STATUS:

2/2/2006:

Amendment SA 2729 proposed by Senator Conrad to Amendment SA 2707. (consideration: CR S489-490)

2/2/2006:

Point of order raised in Senate with respect to amendment SA 2729.

2/2/2006:

Motion to waive the Budget Act with respect to amendment SA 2729 rejected in Senate by Yea-Nay Vote. 44 - 52. Record Vote Number: 3.

2/2/2006:

Amendment SA 2729 ruled out of order by the chair.
(Relevant text follows.)

SEC. 556. INCREASE IN AGE OF MINOR CHILDREN WHOSE UNEARNED INCOME IS TAXED AS IF PARENT'S INCOME.

(a) *In General*.--Section 1(g)(2)(A) (relating to child to whom subsection applies) is amended by striking ``age 14'' and inserting ``age 18''.

(b) *Treatment of Distributions From Qualified Disability Trusts*.--Section 1(g)(4) (relating to net unearned income) is amended by adding at the end the following new subparagraph:

``(C) **TREATMENT OF DISTRIBUTIONS FROM QUALIFIED DISABILITY TRUSTS**.--For purposes of this subsection, in the case of any child who is a beneficiary of a qualified disability trust (as defined in section 642(b)(2)(C)(ii)), any amount included in the income of such child under sections 652 and 662 during a taxable year shall be considered earned income of such child for such taxable year.''.

(c) *Effective Date*.--The amendments made by this section shall apply to taxable years beginning after December 31, 2005.

U.S. Senate Roll Call Votes 109th Congress - 2nd Session

Question: On the Motion (Motion to Waive CBA Conrad Amdt. No. 2729)

Vote Number: 3 **Vote Date:** February 2, 2006, 06:45 PM

Required For Majority: 3/5 **Vote Result:** Motion Rejected

Amendment Number: S.Amdt. 2729 to S.Amdt. 2707 to H.R. 4297 (Tax Relief Extension Reconciliation Act of 2005)

Statement of Purpose: To provide revenue provisions.

Vote Counts:		
	YEAs	44
	NAYs	52
	Not Voting	4

Alphabetical by Senator Name

Akaka (D-HI), **Yea**
Alexander (R-TN), **Nay**
Allard (R-CO), **Nay**
Allen (R-VA), **Nay**
Baucus (D-MT), **Yea**
Bayh (D-IN), **Yea**
Bennett (R-UT), **Nay**
Biden (D-DE), **Yea**
Bingaman (D-NM), **Not Voting**
Bond (R-MO), **Nay**
Boxer (D-CA), **Yea**
Brownback (R-KS), **Nay**
Bunning (R-KY), **Nay**
Burns (R-MT), **Nay**
Burr (R-NC), **Nay**
Byrd (D-WV), **Yea**
Cantwell (D-WA), **Yea**
Carper (D-DE), **Yea**
Chafee (R-RI), **Yea**
Chambliss (R-GA), **Nay**
Clinton (D-NY), **Yea**
Coburn (R-OK), **Nay**
Cochran (R-MS), **Nay**
Domenici (R-NM), **Not Voting**
Dorgan (D-ND), **Yea**
Durbin (D-IL), **Yea**
Ensign (R-NV), **Nay**
Enzi (R-WY), **Nay**
Feingold (D-WI), **Yea**
Feinstein (D-CA), **Yea**
Frist (R-TN), **Nay**
Graham (R-SC), **Nay**
Grassley (R-IA), **Nay**
Gregg (R-NH), **Nay**
Hagel (R-NE), **Nay**
Harkin (D-IA), **Yea**
Hatch (R-UT), **Nay**
Hutchison (R-TX), **Nay**
Inhofe (R-OK), **Not Voting**
Inouye (D-HI), **Yea**
Isakson (R-GA), **Nay**
Jeffords (I-VT), **Yea**
Johnson (D-SD), **Yea**
Kennedy (D-MA), **Yea**
Kerry (D-MA), **Yea**
Kohl (D-WI), **Yea**
Kyl (R-AZ), **Nay**
McConnell (R-KY), **Nay**
Menendez (D-NJ), **Yea**
Mikulski (D-MD), **Yea**
Murkowski (R-AK), **Nay**
Murray (D-WA), **Yea**
Nelson (D-FL), **Yea**
Nelson (D-NE), **Nay**
Obama (D-IL), **Yea**
Pryor (D-AR), **Yea**
Reed (D-RI), **Yea**
Reid (D-NV), **Yea**
Roberts (R-KS), **Nay**
Rockefeller (D-WV), **Yea**
Salazar (D-CO), **Yea**
Santorum (R-PA), **Nay**
Sarbanes (D-MD), **Yea**
Schumer (D-NY), **Yea**
Sessions (R-AL), **Nay**
Shelby (R-AL), **Nay**
Smith (R-OR), **Nay**
Snowe (R-ME), **Nay**
Specter (R-PA), **Nay**
Stabenow (D-MI), **Yea**
Stevens (R-AK), **Nay**

Coleman (R-MN), **Nay**
Collins (R-ME), **Nay**
Conrad (D-ND), **Yea**
Cornyn (R-TX), **Nay**
Craig (R-ID), **Nay**
Crapo (R-ID), **Nay**
Dayton (D-MN), **Yea**
DeMint (R-SC), **Nay**
DeWine (R-OH), **Nay**
Dodd (D-CT), **Yea**
Dole (R-NC), **Nay**
Landrieu (D-LA), **Yea**
Lautenberg (D-NJ), **Yea**
Leahy (D-VT), **Yea**
Levin (D-MI), **Yea**
Lieberman (D-CT), **Yea**
Lincoln (D-AR), **Yea**
Lott (R-MS), **Nay**
Lugar (R-IN), **Nay**
Martinez (R-FL), **Nay**
McCain (R-AZ), **Nay**
Sununu (R-NH), **Nay**
Talent (R-MO), **Nay**
Thomas (R-WY), **Not Voting**
Thune (R-SD), **Nay**
Vitter (R-LA), **Nay**
Voinovich (R-OH), **Nay**
Warner (R-VA), **Nay**
Wyden (D-OR), **Yea**

The New York Times

Despite Pledge, Taxes Increase for Teenagers

By DAVID CAY JOHNSTON

Published: May 21, 2006

The $69 billion tax cut bill that President Bush signed this week tripled tax rates for teenagers with college savings funds, despite Mr. Bush's 1999 pledge to veto any tax increase.

Under the new law, teenagers age 14 to 17 with investment income will now be taxed at the same rate as their parents, not at their own rates. Long-term capital gains and dividends that had been taxed at 5 percent will now be taxed at 15 percent. Interest that had been taxed at 10 percent will now be taxed at as much as 35 percent.

The increases, which are retroactive to the first day of the year, are expected to generate nearly $2.2 billion over 10 years, according to the Congressional Joint Committee on Taxation, which issues the official estimates.

Over all, the tax bill that Mr. Bush signed Wednesday reduces taxes by $69 billion.

Mr. Bush pledged in 1999 to veto any bill that raised taxes. In response to a question about the tax increase on teenagers in the new legislation, the White House issued a statement Friday that made no reference to the tax increase, but recounted the tax cuts the administration has sponsored and stated that President Bush had "reduced taxes on all people who pay income taxes."

Challenged on that point, the White House modified its statement 21 minutes later to say that Mr. Bush had "reduced taxes on virtually all people who pay income taxes."

The deputy White House press secretary, Kenneth A. Lisaius, declined to discuss the reasons Mr. Bush broke his pledge or anything else beyond the modified statement, which emphasized the $880 billion in tax reductions from tax laws Mr. Bush signed in 2001 and 2003.

Americans for Tax Reform, an influential lobbying group that seeks to reduce taxes, had led the drive to press politicians to pledge no new taxes. The pledge has been signed by 256 members of the House and the Senate, nearly all of them Republicans, and by thousands of candidates for state and local office.

The pledge commits signers to "oppose any and all efforts to increase the marginal tax rates for individuals and businesses." Mr. Bush went beyond the pledge when he was seeking the Republican nomination for president.

"If elected president, I will oppose and veto any increase in individual or corporate marginal income tax rates or individual or corporate income tax hikes," he wrote in June 1999 to Grover Norquist, president of the Americans for Tax Reform.

Mr. Norquist, in an interview Thursday, said he was unaware that the bill raised taxes and tax rates on teenagers with college savings funds because "no one here noticed" the provisions. But Mr. Norquist called the bill raising taxes on teenagers with investment income "a technical violation of the pledge" and noted that his group opposes all retroactive tax increases. He pledged to immediately begin a campaign to have the tax increases rescinded.

The New York Times

May 12, 1990, Saturday, Late Edition - Final

SECTION: Section 1; Page 32, Column 1; Financial Desk

LENGTH: 798 words

HEADLINE: Your Money;
The 'Kiddie Tax' And Summer Jobs

BYLINE: By Jan M. Rosen

BODY:
With summer approaching, many students would like to find summer jobs. Some parents, on the other hand, being vaguely aware of the "kiddie tax," are concerned about the effect that might have on the family's finances.

Not to worry, financial experts say. A summer job can bring many benefits, and the kiddie tax applies only to unearned income. Dividends and interest above $1,000 earned on assets held in the name of children under age 14 are taxed at the parents' marginal rate, generally 28 or 33 percent.

Income earned by children of any age is taxed at their own rate - generally the lowest rate, 15 percent - as is unearned income for children 14 and older. This means that young people can earn some of the money they need for personal expenses or a college education and pay little or no taxes; nor are their earnings likely to have any substantial effect on their parents' taxes.

It also means that it can be advantageous for parents who own a business or have a professional practice to employ their children. The children can learn about the business, and the money they earn is shifted into their lower tax bracket.

"Of course, you can't let them go to the beach and pay them," said Herbert Paul, senior tax partner of Mahoney Cohen Paul & Company, an accounting firm in New York. "But if they come into your office or factory, you can pay them a reasonable rate of compensation."

For a responsible youngster, that need not be the very lowest wage , he continued. But it does have to be reasonable for the job performed. There are many things a student can do competently - fill in for the switchboard operator, receptionist or porter; for a secretary or bookkeeper if the young worker has office skills, or do manual labor.

Tamara G. Telesko, a vice president of the Chase Manhattan Bank's private banking division, said she had received many questions from clients about children working. "It makes sense for them to earn money on their own," she said. "It encourages the work ethic, and it gives them a feel for whether that is the kind of job they would like."

Many young people have idealistic visions of what jobs are like, she added, and summer work can help them focus more realistically on what they want to prepare for in college.

Ms. Telesko noted that like any single taxpayer, a student was entitled to a standard deduction of $3,250, so that much could be earned before any tax was due. If the child takes his or her own personal exemption, $2,050 for 1990, even more can be sheltered from taxes, but the parents could not then take a dependency exemption for the child, even if they provided more than half the child's support. Since that exemption is phased out for upper-income taxpayers, shifting income by employing the child can be particularly advantageous for them.

Julian Block, a tax lawyer in Larchmont, N.Y., pointed out that Social Security taxes could also be an important consideration. For low-income people, that tax bite is far more onerous than income taxes - both employee and employer must pay 7.65 percent on the first $51,300 earned this year.

But sole proprietorships and husband-wife partnerships get a break when employing their children. Social Security taxes do not have to be withheld if the children are under age 18, according to the I.R.S. Code section 3121(b)(3)(A). Before 1988, this break applied to children under age 21 and to spouses, he noted, but that is no longer the case.

With the cost of college today - around $6,000 a year for state schools and more than $13,000 for private institutions - it is important for both children and their families to put aside as much as possible, Ms. Telesko said, without undue anxiety about the kiddie tax.

The kiddie tax results from the Tax Reform Act of 1986. Under it, the first $500 of a child's unearned income is tax-free and the next $500 is taxable at the child's rate. For most children, in the 15 percent bracket, only $75 in taxes would be due on the first $1,000 of dividends and interest. Since $1,000 is the earnings on $12,500 invested at 8 percent, transferring that much money to a child, can bring a big tax saving to a family. Parents in the 28 percent bracket would owe $280 in taxes on that amount of earnings; those in the 33 percent bracket would owe $333.

Series EE savings bonds can be excellent vehicles for college savings. Investors can elect to receive the interest after the child is age 14 so that it is taxed at the child's rate. And taxpayers with adjusted gross income of $60,000 or less who buy Series EE bonds issued after 1989 and redeem them to pay for their own higher-education expenses or those of a dependent will owe no tax on the interest. The exclusion is phased out for those with incomes of $60,000 to $90,000.