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INSIGHT

The Kiddie Tax and Military Survivors' Benefits

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Some military families have discovered that they owe higher taxes for 2018 on distributions from their military survivors' benefits than they had in previous years. This change in tax treatment is related to temporary changes to the "kiddie tax" in the 2017 tax revision (P.L. 115-97).

Military Survivor Benefits to Children

Retired servicemembers may elect to provide their spouses and/or children with up to 55% of their pension following the member's death as part of a program called the Survivor Benefit Plan (SBP) (10 U.S.C. 1448). In 2001 (P.L. 107-107), Congress expanded eligibility for this benefit to dependents of servicemembers who die while in active service. The Department of Defense (DOD) distributes SBP payments as a taxable monthly annuity for the lifetime of a surviving spouse and up to age 18 or 22 for most surviving children. Due to a dollar-for-dollar offset with another federal benefit for some surviving spouses called Dependency and Indemnity Compensation (DIC), it is often more financially beneficial for the family to elect children as the SBP beneficiaries to avoid this offset. As with SBP, survivors of servicemembers who die on active duty are also automatically eligible for DIC. As of September 30, 2017, DOD reported 2,699 dependent children receiving SBP annuities due to a parent's death in retirement and an additional 6,916 receiving an annuity due to a parent's death during active service. The amount of the SBP annuity varies and depends on the servicemember's retired pay base at the time of death. On average, a survivor receives about $1,050 per month from SBP alone (not including other benefits, such as Social Security).

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What Is the Kiddie Tax?

The kiddie tax was first enacted as part of the Tax Reform Act of 1986. Its purpose was to prevent wealthy parents from reducing their own tax liability by creating investment accounts and trusts in the names of their children, who were typically subject to lower tax rates.

Generally, a child must file a separate return to report his or her income (like any other taxpayer). Children with unearned income above $2,100 for 2018 ($2,200 for 2019) may be subject to the kiddie tax. The kiddie tax applies regardless of whether the child may be claimed as a dependent on his or her parents' return.

A child is subject to kiddie tax on all net unearned income. This is the excess of their adjusted gross income for the tax year that is not earned income over the sum of (1) the amount of the child's limited standard deduction ($1,050 for 2018 and $1,100 for 2019) and (2) the greater of the amount of the child's limited standard deduction or itemized deductions attributable to unearned income for the year.

The parents may elect to include on their return the unearned income of a child to avoid the kiddie tax. If a child's gross income is only from interest and dividends and the amount of the gross income is greater than $1,050 in 2018 ($1,100 for 2019) and less than $10,500 in 2018 ($11,000 for 2019), the parents may elect to report the child's gross income on the parents' return, and the child is treated as having no gross income. The election is made by filing Form 8814. A tax of 10% is imposed on up to $1,050 in 2018 ($1,100 for 2019) of the child's gross income included on the parents' return.

Computation of the Kiddie Tax Before and After the 2017 Tax Revision

Before 2018 and after 2025, the child's tax liability under the kiddie tax is equal to the greater of (1) the tax on all of the child's income without regard to the kiddie tax or (2) the sum of the tax on the child's total income reduced by net unearned income plus the child's share of the "allocable parent tax." The allocable parent tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. The effect is that the child's unearned income is taxed at the higher of the child's or parent's marginal tax rate.

The 2017 tax revision (P.L. 115-97) changed the calculation of the kiddie tax by taxing a child's unearned income according to the tax rates that apply to estates and trusts rather than through the allocable parent tax method. The graduated rates for income from estates and trusts apply at relatively low levels, though, compared to ordinary income tax rates.

Legislative Options

Congress could consider tax policy options to prevent a child's SBP payments from being taxed at a rate higher than either the parent's or child's marginal income tax rate. A special rule could be enacted to the temporary kiddie tax provisions. For example, SBP distributions could be taxed under a parent's income tax return as ordinary income without regard to the limits on the election under current law, described above. On May 2, a group of lawmakers introduced legislation that would permanently define SBP distributions to a child as earned income, therefore exempting them from the kiddie tax. This option would likely be more generous than taxing the SBP benefits on a parent's return, because children often face a lower marginal tax rate than their parents. Congress could also enact legislation to exclude SBP benefits from gross income either temporarily or permanently.

As another option, Congress could authorize a temporary *SBP open season* for families negatively affected by the tax law to change the beneficiary from the child or children to the widowed spouse. The attractiveness to families of this option would depend on factors such as the age of the children, the total household income, and interactions with other federal benefits.