

Alert

Expanded Kiddie Tax Hits More Tribal Minors' Trust Distributions

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Special tax rules that generally apply to investment income earned by children under the age of 18, commonly known as the "kiddie tax," may leave tribal minors' trust beneficiaries with significantly higher tax bills than anticipated. Beginning this year (2008), not only children under the age of 18, but also certain older children will be taxed at their parents' tax rate (assuming such rate is higher than the child's rate) on all unearned income exceeding \$1,800.

4. At least one of the child's parents was alive at the end of 2008.
5. The child or young adult does not file a joint tax return for 2008.

If subject to the kiddie tax, the child will be taxed at his or her rate on the first \$1,800 of unearned income, and at his or her parent's rate for any excess income. To report such income, the child should file a separate Form 1040A or Form 1040. The child's parents can elect to choose to pay their child's tax along with their own by filing a Form 8814.



How the Kiddie Tax Applies

The kiddie tax rules apply to "children" (including young adults) who meet all of the following conditions:

1. The child had more than \$1,800 of "unearned income" (a category that includes Indian tribal gaming distributions, minors' trust distributions and Alaska Native Corporation dividends, as well as interest, corporate dividends and capital gains).
2. The child is required to file a tax return.¹
3. The child either:
 - a. was under the age of 18 at the end of 2008, or
 - b. was 18 at the end of 2008 and did not have earned income that was more than half of the child's support, or
 - c. was over age 18 and under age 24 at the end of 2008, did not have earned income that was more than half of the child's support *and* was a full-time student.



Examples of How the Kiddie Tax Applies in Tribal Context

Example #1:

Pursuant to its revenue allocation plan, the Tribe annually contributes \$10,000 for each tribal minor to a minors' trust. The minors' trust does not meet the requirements for tax deferral as set forth by the IRS in Revenue Procedure 2003-14, and thus, the contributions are subject to tax every year. The tribal minors have no other income; their parents' marginal rate of tax is 25 percent. If the kiddie tax rules did not apply, each tribal minor would owe approximately \$1,009 in tax. However, under the kiddie tax, each tribal minor owes approximately \$2,140, more than double the amount each tribal minor would have owed had the kiddie tax not applied.

Comment: *The application of the kiddie tax in this situation can be largely avoided by conforming the trust to Revenue Procedure 2003-14 so that there is no constructive receipt of trust income until the minor attains age 18 or older.*

Example #2:

Assume the same facts as Example #1, except the minors' trust meets the requirements set forth in Revenue Procedure 2003-14, and thus, the contributed funds qualify for tax deferral. Further, the minors' trust pays each beneficiary one-fifth of his or her minors' trust balance for five consecutive years starting when the beneficiary turns 18 years old. Assuming a rate of return of approximately 3.25 percent, each payment would be approximately \$50,000. If a beneficiary has little or no earned income and enrolls in college full-time, he or she will pay federal income tax on the yearly trust payout which is approximately \$12,140 each year. If the kiddie tax did not apply, his or her annual tax bill would be approximately \$8,754.

Comment: The differential tax increase assumes that the young adults are not in the same tax bracket as their parent(s). This would not be the case if the tribal young adult qualified to receive a per capita payment equal to that of their parent(s) and the parent(s) received no other income.

Prospects for Legislative Change

It is extremely doubtful that Congress intended the kiddie tax to apply to minors' trust distributions – particularly since the amounts are not derived from assets transferred to the

child by his or her parents and the income is already subject to income tax withholding under Internal Revenue Code Section 3402(r). The kiddie tax does exempt disability trust distributions by treating them as earned, rather than unearned income.

Holland & Knight lawyers are in the process of determining the extent of congressional support for a legislative proposal to trust minors' trust distributions as earned income for kiddie tax purposes.

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¹ A tax return generally must be filed for any child whose income includes unearned income that totals more than \$900 (for tax year 2008).

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With a deep understanding and respect for the traditional values that set tribes apart, Holland & Knight's Indian Law Practice Group is committed to providing tribal governments with the same high quality of legal representation demanded by other governments and international corporations – the kind of service tribes require to protect their sovereignty and to prosper in today's and tomorrow's world. Our Indian Law Practice Group utilizes the diverse talents of our attorneys and other professionals to protect tribal sovereignty and resources, develop reservation economies and infrastructure, preserve basic human rights, such as access to health care, and enhance tribal governance and business structures. We understand the challenges tribes face, and are able to provide full-service, “one-stop” legal and strategic advice and counsel on all of the critical issues.

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