DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR Richard Clement
EITC study

FROM: Assistant Chief Counsel
(Employee Benefits and Exempt Organizations)

SUBJECT: Investment income for purposes of the earned income credit investment income limit

This Chief Counsel Advice responds to your memorandum dated July 27, 1999. Chief Counsel Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUE:

If a parent makes an election to include his or her child's income on the parent's federal income tax return, pursuant to section 1(g)(7) of the Internal Revenue Code, are the child's interest, dividends, and capital gain distributions considered to be the interest, dividends, and capital gain distributions of the parent for purposes of 32(i) of the Code?

CONCLUSION:

The child's interest, dividends, and capital gain distributions are considered to be the parent's interest, dividends, and capital gain distributions for purposes of section 32(i) of the Code if the parent includes the child's income on the parent's federal income tax return.

FACTS:

A parent elects under section 1(g)(7) to report the income of his or her child on the parent's federal income tax return.

LAW AND ANALYSIS:

Section 32 of the Code allows an earned income credit (EIC) to eligible individuals. Section 32(i) denies the EIC to an otherwise eligible individual if the individual’s “disqualified income” exceeds a specified level for the taxable year for which the credit is claimed. Section 32(i)(2) defines “disqualified income” to include “interest or dividends to the extent includible in gross income for the taxable year.”

Section 1(g) of the Code taxes certain unreported income of minor children as if it were the parent's income. Section 1(g)(3) computes an allocable parental tax, by applying the parent's tax rate to the income of the parent plus the unearned income of minor children subject to this section. Each child is then taxed a proportionate amount of the allocable parental tax. However, the parent does not report the child's income, and items on the parent's return are not affected by the child's income. Section 1(g)(3)(A), flush language; Temp. Reg. section 1.1(i)-1T, Q&A 21.

Section 1(g)(7) provides that, under certain circumstances, the parent can instead elect to include the child's unearned income on the parent's return. This election can only be made if the child's income consists of interest, dividends (including Alaska Permanent Fund dividends) and capital gain distributions. If the election is made, the child is treated as having no income for the year and the child does not have to file a federal income tax return.

The parent reports the child's unearned income by attaching a Form 8814, Parent's Election To Report Child's Interest and Dividends, to the parent's return for each child. Using Form 8814, an amount determined with reference to the standard deduction (currently $700) is not taxed and is subtracted from the child's total income. Next, an amount (also currently $700) which is taxed at a 15 percent is also subtracted from the child's income. The tax computed on that amount is carried over to line 40 of the parent's Form 1040, U.S. Individual Income Tax Return. The amount of the child's income remaining is then included in the parent's income. The child's interest and dividend income is included on line 21 of the parent's Form 1040 (other income), and the child's capital gain distributions are included in the parent's Schedule D.[1]

Including the child's income on the parent's return can affect the parent's deductions and credits that are based on adjusted gross income, as well as phase-outs, limitations and floors.[2] As noted above, the flush language in section 1(g)(3) of the Code, and Q&A 21 of Temp. Reg. section 1.1(i)-1T state that the child's income does not affect these items of the parent, but this is with respect to the taxation of the child at the parent's rate, where the child files a return. Where the parent instead elects to include the child's income on the parent's return, the adjusted gross income of the parent is increased by the child's income so reported.

Further, the child's income retains its character on the return of the parent. For example, capital gain distributions of the child are included as such on the parent's Schedule D. Section 1(g)(7)(B)(iii) of the Code provides that the parent must treat any tax exempt interest of the child from specified private activity bonds under section 57(a)(5) as a tax preference item of the parents. Finally, Publication 929, page 6, and the instructions to Form 8814 specifically state that the child's investment income is considered to be the parent's investment income for purposes of computing the parent's investment interest expense deductions.

Because the child's income retains its character on the return of the parent, if a parent chooses under section 1(g)(7) to treat his or her child's income as the parent's income, then the child's interest, dividends, and capital gain distributions will be considered to be the interest, dividends, and capital gain distributions of the parent for purposes of section 32(i).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Because of publication deadlines, the conclusion that a child's investment income is treated as investment income of the parent in cases where the parent makes an election under section 1(g)(7) will not be reflected in the publications or form instructions for the 1999 tax year. It should be reflected in the publications and form instructions for the 2000 tax year. Because taxpayers will not have notice of this position, you may wish to consider whether to postpone addressing these cases until the 2000 tax year.

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[1] Publication 929, Tax Rules for Children and Dependents, contains a worksheet to determine the amount of capital gain proportionally included in the income to be included on the parent's return.

[2] See pages 6-7 of Publication 929, and the example on page 8.

If you have any further questions, please call (202) 622-6060.

MARY OPPENHEIMER
Assistant Chief Counsel
(Employee Benefits and
Exempt Organizations)

By: ______________________
MARK SCHWIMMER
Branch Chief
CC:EBEO:Br:4