ordinary income (determined under §1.751–1(a)(2)) and a $1,000 long-term capital loss on account of the sale of B's interest in *PRS*.

Example 4. Collectibles gain in an S corporation. (i) A corporation (*X*) has always been an S corporation and is owned by individuals *A*, *B*, and *C*. In 1996, *X* invested in antiques. Subsequent to their purchase, the antiques appreciated in value by $300. *A* owns one-third of the shares of *X* stock and has held that stock for more than one year. *A*'s adjusted basis in the *X* stock is $100. If *A* were to sell all of *A*'s *X* stock to *T* for $150, *A* would realize $50 of pre-look-through long-term capital gain.

(ii) If *X* were to sell its antiques in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer to *T*, *A* would be allocated $100 of gain on account of the sale. Therefore, *A* will recognize $100 of collectibles gain (look-through capital gain) on account of the collectibles held by *X*.

(iii) The difference between the transferor's pre-look-through long-term capital gain or loss ($50) and the look-through capital gain determined under this section ($100) is the transferor's residual long-term capital gain or loss on the sale of the S corporation stock. Under these facts, *A* will recognize $100 of collectibles gain and a $50 residual long-term capital loss on account of the sale of *A*'s interest in *X*.

Example 5. Sale or exchange of partnership interest where part of the interest has a short-term holding period. (i) *A*, *B*, and *C* form an equal partnership (*PRS*). In connection with the formation, *A* contributes $5,000 in cash and a capital asset with a fair market value of $5,000 and a basis of $2,000; *B* contributes $7,000 in cash and a collectible with a fair market value of $3,000 and a basis of $3,000; and *C* contributes $10,000 in cash. At the time of the contribution, *A* had held the contributed property for two years. Six months later, when *A*'s basis in *PRS* is $7,000, *A* transfers *A*'s interest in *PRS* to *T* for $14,000 at a time when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	ASSETS	
	Adjusted basis	Market value
Cash	$22,000	$22,000
Unrealized Receivables	0	6,000
Capital Asset	2,000	5,000
Collectible	3,000	9,000
Capital Assets	5,000	14,000
Total	27,000	42,000

(ii) Although at the time of the transfer *A* has not held *A*'s interest in *PRS* for more than one year, 50 percent of the fair market value of *A*'s interest in *PRS* was received in exchange for a capital asset with a long-term holding period. Therefore, 50 percent of *A*'s interest in *PRS* has a long-term holding period. See §1.1223–3(b)(1).

(iii) If *PRS* were to sell all of its section 751 property in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated $2,000 of ordinary income. Accordingly, *A* will recognize $2,000 ordinary income and $5,000 ($7,000–$2,000) of capital gain on account of the transfer to *T* of *A*'s interest in *PRS*. Fifty percent ($2,500) of that gain is long-term capital gain and 50 percent ($2,500) is short-term capital gain. See §1.1223–3(c)(1).

(iv) If the collectible were sold or exchanged in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated $2,000 of gain attributable to the collectible. The gain attributable to the collectible that is allocable to the portion of the transferred interest in *PRS* with a long-term holding period is $1,000 (50 percent of $2,000). Accordingly, *A* will recognize $1,000 of collectibles gain on account of the transfer of *A*'s interest in *PRS*.

(v) The difference between the amount of pre-look-through long-term capital gain or loss ($2,500) and the look-through capital gain ($1,000) is the amount of residual long-term capital gain or loss that *A* will recognize on account of the transfer of *A*'s interest in *PRS*. Under these facts, *A* will recognize a residual long-term capital gain of $1,500 and a short-term capital gain of $2,500.

(g) *Effective date.* This section applies to transfers of interests in partnerships, S corporations, and trusts that occur on or after September 21, 2000.

[T.D. 8902, 65 FR 57096, Sept. 21, 2000]

§ 1.1(i)–1T Questions and answers relating to the tax on unearned income certain minor children (Temporary).

IN GENERAL

Q–1. To whom does section 1(i) apply?

A–1. Section 1(i) applies to any child who is under 14 years of age at the close of the taxable year, who has at least one living parent at the close of the taxable year, and who recognizes over $1,000 of unearned income during the taxable year.

Q–2. What is the effective date of section 1(i)?

A–2. Section 1(i) applies to taxable years of the child beginning after December 31, 1986.

COMPUTATION OF TAX

Q–3. What is the amount of tax imposed by section 1 on a child to whom section 1(i) applies?

A–3. In the case of a child to whom section 1(i) applies, the amount of tax imposed by section 1 equals the greater of (A) the tax imposed by section 1 without regard to section 1(i) or (B) the sum of the tax that would be imposed by section 1 if the child's taxable income was reduced by the child's net unearned income, plus the child's share of the allocable parental tax.

Q–4. What is the allocable parental tax?

A–4. The allocable parental tax is the excess of (A) the tax that would be imposed by section 1 on the sum of the parent's taxable income plus the net unearned income of all children of such parent to whom section 1(i) applies, over (B) the tax imposed by section 1 on the parent's taxable income. Thus, the allocable parental tax is not computed with reference to unearned income of a child over 14 or a child under 14 with less than $1,000 of unearned income. *See* A–10 through A–13 for rules regarding the determination of the parent(s) whose taxable income is taken into account under section 1(i). *See* A–14 for rules regarding the determination of children of the parent whose net unearned income is taken into account under section 1(i).

Q–5. What is the child's share of the allocable parental tax?

A–5. The child's share of the allocable parental tax is an amount that bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the total net unearned income of all children of such parent to whom section 1(i) applies. See A–14.

Example 1. During 1988, D, and a 12 year old, receives $5,000 of unearned income and no earned income. D has no itemized deductions and is not eligible for a personal exemption. D's parents have two other children, E, a 15 year old, and F, a 10 year old. E has $10,000 of unearned income and F has $100 of unearned income. D's parents file a joint return for 1988 and report taxable income of $70,000. Neither D's nor his parent's taxable income is attributable to net capital gain. D's tax liability for 1988, determined without regard to section 1(i), is $675 on $4,500 of taxable income ($5,000 less $500 allowable standard deduction). In applying section 1(i), D's tax would be equal to the sum of (A) the tax that would be imposed on D's taxable income if it were reduced by any net unearned income, plus (B) D's share of the allocable parental tax. Only D's unearned income is taken into account in determining the allocable parental tax because E is over 14 and F has less than $1,000 of unearned income. *See* A–4. D's net unearned income is $4,000 ($4,500 taxable unearned income less $500). The tax imposed on D's taxable income as reduced by D's net unearned income is $75 ($500×15%). The allocable parental tax is $1,225, the excess of $16,957.50 (the tax on $74,000, the parent's taxable income plus D's net unearned income) over $15,732.50 (the tax on $70,000, the parent's taxable income). *See* A–4. Thus, D's tax under section 1(i)(1)(B) is $1,300 ($1,225+$75). Since this amount is greater than the amount of D's tax liability as determined without regard to section 1(i), the amount of tax imposed on D for 1988 is $1,300. *See A–3.*

Example 2. H and W have 3 children, A, B, and C, who are all under 14 years of age. For the taxable year 1988, H and W file a joint return and report taxable income of $129,750. The tax imposed by section 1 on H and W is $35,355. A has $5,000 of net unearned income and B and C each have $2,500 of net unearned income during 1988. The allocable parental tax imposed on A, B, and C's combined net unearned income of $10,000 is $3,300. This tax is the excess of $38,655, which is the tax imposed by section 1 on $139,750 ($129,750+10,000), over $35,355 (the tax imposed by section 1 on H and W's taxable income of $129,750). *See* A–4. Each child's share of the allocable parental tax is an amount that bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the total net unearned income of A, B, and C. Thus, A's share of the allocable parental tax is $1,650 (5,000÷10,000×3,300) and B and C's share of the tax is $825 (2,500÷10,000×3,300) each. *See* A–5.

DEFINITION OF NET UNEARNED INCOME

Q–6. What is net unearned income?

A–6. Net unearned income is the excess of the portion of adjusted gross income for the taxable year that is not ''earned income'' as defined in section 911(d)(2) (income that is not attributable to wages, salaries, or other amounts received as compensation for personal services), over the sum of the standard deduction amount provided for under section 63 (c)(5)(A) ($500 for 1987 and 1988; adjusted for inflation thereafter), plus the greater of (A) $500 (adjusted for inflation after 1988) or (B) the amount of allowable itemized deductions that are directly connected with the production of unearned income. A child's net unearned income for any taxable year shall not exceed the child's taxable income for such year.

Example 3. A is a child who is under 14 years of age at the end of the taxable year 1987. Both of A's parents are alive at this time. During 1987, A receives $3,000 of interest from a bank savings account and earns $1,000 from a paper route and performing odd jobs. A has no itemized deductions for 1987. A's standard deduction is $1,000, which is an amount equal to A's earned income for 1987. Of this amount, $500 is applied against A's unearned income and the remaining $500 is applied against A's earned income. Thus, A's $500 of taxable earned income ($1,000 less the remaining $500 of the standard deduction) is taxed without regard to section 1 (i); A has $2,500 of taxable unearned income ($3,000 gross unearned income less $500 of the standard deduction) of which $500 is taxed without regard to section 1(i). The remaining $2,000 of taxable unearned income is A's net unearned income and is taxed under section 1(i).

Example 4. B is a child who is subject to tax under section 1(i). B has $400 of earned income and $2,000 of unearned income. B has itemized deductions of $800 (net of the 2 percent of adjusted gross income (AGI) floor on miscellaneous itemized deductions under section 67) of which $200 are directly connected with the production of unearned income. The amount of itemized deductions that B may apply against unearned income is equal to the greater of $500 or the deductions directly connected with the production of unearned income. *See* A–6. Thus, $500 of B's itemized deductions are applied against the $2,000 of unearned income and the remaining $300 of deductions are applied against earned income. As a result, B has taxable earned income of $100 and taxable unearned income of $1,500. Of these amounts, all of the earned income and $500 of the unearned income are taxed without regard to section 1(i). The remaining $1,000 of unearned income is net unearned income and is taxed under section 1(i).

UNEARNED INCOME SUBJECT TO TAX UNDER SECTION 1(I)

Q–7. Will a child be subject to tax under section 1(i) on net unearned income (as defined in section 1(i) (4) and A–6 of this section) that is attributable to property transferred to the child prior to 1987?

A–7. Yes. The tax imposed by section 1(i) on a child's net unearned income applies to any net unearned income of the child for taxable years beginning after December 31, 1986, regardless of when the underlying assets were transferred to the child.

Q–8. Will a child be subject to tax under section 1(i) on net unearned income that is attributable to gifts from persons other than the child's parents or attributable to assets resulting from the child's earned income?

A–8. Yes. The tax imposed by section 1(i) applies to all net unearned income of the child, regardless of the source of the assets that produced such income. Thus, the rules of section 1(i) apply to income attributable to gifts not only from the parents but also from any other source, such as the child's grandparents. Section 1(i) also applies to unearned income derived with respect to assets resulting from earned income of the child, such as interest earned on bank deposits.

Example 5. A is a child who is under 14 years of age at the end of the taxable year beginning on January 1, 1987. Both of A's parents are alive at the end of the taxable year. During 1987, A receives $2,000 in interest from his bank account and $1,500 from a paper route. Some of the interest earned by A from the bank account is attributable to A's paper route earnings that were deposited in the account. The balance of the account is attributable to cash gifts from A's parents and grandparents and interest earned prior to 1987. Some cash gifts were received by A prior to 1987. A has no itemized deductions and is eligible to be claimed as a dependent on his parent's return. Therefore, for the taxable year 1987, A's standard deduction is $1,500, the amount of A's earned income. Of this standard deduction amount, $500 is allocated against unearned income and $1,000 is allocated against earned income. A's taxable unearned income is $1,500 of which $500 is taxed without regard to section 1(i). The remaining taxable unearned income of $1,000 is net unearned income and is taxed under section 1(i). The fact that some of A's unearned income is attributable to interest on principal created by earned income and gifts from persons other than A's parents or that some of the unearned income is attributable to property transferred to A prior to 1987, will not affect the tax treatment of this income under section 1(i). *See* A–8.

Q–9. For purposes of section 1(i), does income which is not earned income (as defined in section 911(d)(2)) include social security benefits or pension benefits that are paid to the child?

A–9. Yes. For purposes of section 1(i), earned income (as defined in section 911(d)(2)) does not include any social security or pension benefits paid to the child. Thus, such amounts are included in unearned income to the extent they are includible in the child's gross income.

DETERMINATION OF THE PARENT'S TAXABLE INCOME

Q–10. If a child's parents file a joint return, what is the taxable income that must be taken into account by the child in determining tax liability under section 1(i)?

A–10. In the case of parents who file a joint return, the parental taxable income to be taken into account in determining the tax liability of a child is the total taxable income shown on the joint return.

Q–11. If a child's parents are married and file separate tax returns, which parent's taxable income must be taken into account by the child in determining tax liability under section 1(i)?

A–11. For purposes of determining the tax liability of a child under section 1(i), where such child's parents are married and file separate tax returns, the parent whose taxable income is the greater of the two for the taxable year shall be taken into account.

Q–12. If the parents of a child are divorced, legally separated, or treated as not married under section 7703(b), which parent's taxable income is taken into account in computing the child's tax liability?

A–12. If the child's parents are divorced, legally separated, or treated as not married under section 7703(b), the taxable income of the custodial parent (within the meaning of section 152(e)) of the child is taken into account under section 1(i) in determining the child's tax liability.

Q–13. If a parent whose taxable income must be taken into account in determining a child's tax liability under section 1(i) files a joint return with a spouse who is not a parent of the child, what taxable income must the child take into account?

A–13. The amount of a parent's taxable income that a child must take into account for purposes of section 1(i) where the parent files a joint return with a spouse who is not a parent of the child is the total taxable income shown on such joint return.

CHILDREN OF THE PARENT

Q–14. In determining a child's share of the allocable parental tax, is the net unearned income of legally adopted children, children related to such child by half-blood, or children from a prior marriage of the spouse of such child's parent taken into account in addition to the natural children of such child's parent?

A–14. Yes. In determining a child's share of the allocable parental tax, the net unearned income of all children subject to tax under section 1(i) and who use the same parent's taxable income as such child to determine their tax liability under section 1(i) must be taken into account. Such children are taken into account regardless of whether they are adopted by the parent, related to such child by half-blood, or are children from a prior marriage of the spouse of such child's parent.

RULES REGARDING INCOME FROM A TRUST OR SIMILAR INSTRUMENT

Q–15. Will the unearned income of a child who is subject to section 1(i) that is attributable to gifts given to the child under the Uniform Gift to Minors Act (UGMA) be subject to tax under section 1(i)?

A–15. Yes. A gift under the UGMA vests legal title to the property in the child although an adult custodian is given certain rights to deal with the property until the child attains majority. Any unearned income attributable to such a gift is the child's unearned income and is subject to tax under section 1(i), whether distributed to the child or not.

Q–16. Will a child who is a beneficiary of a trust be required to take into account the income of a trust in determining the child's tax liability under section 1(i)?

A–16. The income of a trust must be taken into account for purposes of determining the tax liability of a beneficiary who is subject to section 1(i) only to the extent it is included in the child's gross income for the taxable year under sections 652(a) or 662(a). Thus, income from a trust for the fiscal taxable year of a trust ending during 1987, that is included in the gross income of a child who is subject to section 1(i) and who has a calendar taxable year, will be subject to tax under section 1(i) for the child's 1987 taxable year.

SUBSEQUENT ADJUSTMENTS

Q–17. What effect will a subsequent adjustment to a parent's taxable income have on the child's tax liability if such parent's taxable income was used to determine the child's tax liability under section 1(i) for the same taxable year?

A–17. If the parent's taxable income is adjusted and if, for the same taxable year as the adjustment, the child paid tax determined under section 1(i) with reference to that parent's taxable income, then the child's tax liability under section 1(i) must be recomputed using the parent's taxable income as adjusted.

Q–18. In the case where more than one child who is subject to section 1(i) uses the same parent's taxable income to determine their allocable parental tax, what effect will a subsequent adjustment to the net unearned income of one child have on the other child's share of the allocable parental tax?

A–18. If, for the same taxable year, more than one child uses the same parent's taxable income to determine their share of the allocable parental tax and a subsequent adjustment is made to one or more of such children's net unearned income, each child's share of the allocable parental tax must be recomputed using the combined net unearned income of all such children as adjusted.

Q–19. If a recomputation of a child's tax under section 1(i), as a result of an adjustment to the taxable income of the child's parents or another child's net unearned income, results in additional tax being imposed by section 1(i) on the child, is the child subject to interest and penalties on such additional tax?

A–19. Any additional tax resulting from an adjustment to the taxable income of the child's parents or the net unearned income of another child shall be treated as an underpayment of tax and interest shall be imposed on such underpayment as provided in section 6601. However, the child shall not be liable for any penalties on the underpayment resulting from additional tax being imposed under section 1(i) due to such an adjustment.

Example 6. D and M are the parents of C, a child under the age of 14. D and M file a joint return for 1988 and report taxable income of $69,900. C has unearned income of $3,000 and no itemized deductions for 1988. C properly reports a total tax liability of $635 for 1988. This amount is the sum of the allocable parental tax of $560 on C's net unearned income of $2,000 (the excess of $3,000 over the sum of $500 standard deduction and the first $500 of taxable unearned income) plus $75 (the tax imposed on C's first $500 of taxable unearned income). *See* A–3. One year later, D and M's 1988 tax return is adjusted on audit by adding an additional $1,000 of taxable income. No adjustment is made to the amount reported as C's net unearned income for 1988. However, the adjustment to D and M's taxable income causes C's tax liability under section 1(i) for 1988 to be increased by $50 as a result of the phase-out of the 15 percent rate bracket. *See* A–20. In addition to this further tax liability, C will be liable for interest on the $50. However, C will not have to pay any penalty on the delinquent amount.

MISCELLANEOUS RULES

Q–20. Does the phase-out of the parent's 15 percent rate bracket and personal exemptions under section 1(g), if applicable, have any effect on the calculation of the allocable parental tax imposed on a child's net unearned income under section 1(i)?

A–20. Yes. Any phase-out of the parent's 15 percent rate bracket or personal exemptions under section 1(g) is given full effect in determining the tax that would be imposed on the sum of the parent's taxable income and the total net unearned income of all children of the parent. Thus, any additional tax on a child's net unearned income resulting from the phase-out of the 15 percent rate bracket and the personal exemptions is reflected in the tax liability of the child.

Q–21. For purposes of calculating a parent's tax liability or the allocable parental tax imposed on a child, are other phase-outs, limitations, or floors on deductions or credits, such as the phase-out of the $25,000 passive loss allowance for rental real estate activities under section 469(i)(3) or the 2 percent of AGI floor on miscellaneous itemized deductions under section 67, affected by the addition of a child's net unearned income to the parent's taxable income?

A–21. No. A child's net unearned income is not taken into account in computing any deduction or credit for purposes of determining the parent's tax liability or the child's allocable parental tax. Thus, for example, although the amounts allowable to the parent as a charitable contribution deduction, medical expense deduction, section 212 deduction, or a miscellaneous itemized deduction are affected by the amount of the parent's adjusted gross income, the amount of these deductions that is allowed does not change as a result of the application of section 1(i) because the amount of the parent's adjusted gross income does not include the child's net unearned income. Similarly, the amount of itemized deductions that is allowed to a child does not change as a result of section 1(i) because section 1(i) only affects the amount of tax liability and not the child's adjusted gross income.

Q–22. If a child is unable to obtain information concerning the tax return of the child's parents directly from such parents, how may the child obtain information from the parent's tax return which is necessary to determine the child's tax liability under section 1(i)?

A–22. Under section 6103(e)(1)(A)(iv), a return of a parent shall, upon written request, be open to inspection or disclosure to a child of that individual (or the child's legal representative) to the extent necessary to comply with section 1(i). Thus, a child may request the Internal Revenue Service to disclose sufficient tax information about the parent to the child so that the child can properly file his or her return.

[T.D. 8158, 52 FR 33579, Sept. 4, 1987; 52 FR 36133, Sept. 25, 1987]

§ 1.2–1 Tax in case of joint return of husband and wife or the return of a surviving spouse.

(a) *Taxable year ending before January 1, 1971.* (1) For taxable years ending before January 1, 1971, in the case of a joint return of husband and wife, or the return of a surviving spouse as defined in section 2(b), the tax imposed by section 1 shall be twice the tax that would be imposed if the taxable income were reduced by one-half. For rules relating to the filing of joint returns of husband and wife, see section 6013 and the regulations thereunder.

(2) The method of computing, under section 2(a), the tax of husband and wife in the case of a joint return, or the tax of a surviving spouse, is as follows:

(i) First, the taxable income is reduced by one-half. Second, the tax is determined as provided by section 1 by using the taxable income so reduced. Third, the tax so determined, which is the tax that would be determined if the taxable income were reduced by one-half, is then multiplied by two to produce the tax imposed in the case of the joint return or the return of a surviving spouse, subject, however, to the allowance of any credits against the tax under the provisions of sections 31 through 38 and the regulations thereunder.

(ii) The limitation under section 1(c) of the tax to an amount not in excess of a specified percent of the taxable income for the taxable year is to be applied before the third step above, that is, the limitation to be applied upon the tax is determined as the applicable specified percent of one-half of the taxable income for the taxable year (such one-half of the taxable income being the actual aggregate taxable income of the spouses, or the total taxable income of the surviving spouse, as the case may be, reduced by one-half). For the percent applicable in determining the limitation of the tax under section 1(c), see § 1.1–2(a). After such limitation is applied, then the tax so limited is multiplied by two as provided in section 2(a) (the third step above).

(iii) The following computation illustrates the method of application of section 2(a) in the determination of the tax of a husband and wife filing a joint return for the calendar year 1965. If the combined gross income is $8,200, and the only deductions are the two exemptions of the taxpayers under section 151(b) and the standard deduction under section 141, the tax on the joint return for 1965, without regard to any credits against the tax, is $1,034.20 determined as follows:

1. Gross income		$8,200.00
2. Less:		
Standard deduction, section 141	$820	
Deduction for personal exemption, section 151	1,200	2,020.00