

**INTERNAL REVENUE SERVICE**  
**NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**

Number: **200222003**  
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Index (UIL) Nos.: 61.00-00, 451.00-00, 677.00-00, 3402.20-00  
CASE MIS No.: TAM-112625-00/CC:ITA:B3

Director, Indian Tribal Governments (T:GE:ITG)

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No:  
Years Involved:  
Date of Conference:

LEGEND:

Beneficiaries =

Tribe =

Plan =

Amended Plan =

Minors =

Non-competent adults =

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Trust Agreement =

Trust =

Trustee =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Year 1 =

Year 2 =

#### ISSUES:

1. Whether the Beneficiaries should recognize gross income under § 61 of the Internal Revenue Code upon the funding of the Trust with per capita distributions and as income is earned on those amounts while in the Trust, or upon the actual distribution of amounts from the Trust.

2. Whether the withholding provisions of § 3402(r) apply to the per capita distributions upon the funding of the Trust, or upon the actual distribution of amounts to the Beneficiaries from the Trust.

#### CONCLUSIONS:

1. The Beneficiaries recognize gross income when the amounts are actually distributed from the Trust. Thus, the Beneficiaries do not recognize gross income when the per capita distributions are placed in the Trust. The Beneficiaries also do not

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recognize gross income with respect to the annual earnings of the Trust attributable to the per capita distributions until the earnings are actually distributed.

2. The withholding provisions of § 3402(r) apply at the time the amounts are distributed from the Trust and included in the gross income of the Beneficiaries under § 61.

FACTS:

Congress enacted the Indian Gaming Regulatory Act, 25 U.S.C. 2701 (IGRA), on October 17, 1988. Section 3 of IGRA provides that the purpose of IGRA is to provide a statutory basis for the operation of gaming by Indian tribes as a means of promoting tribal economic development, self-sufficiency, and strong tribal governments, and to declare that the establishment of independent federal regulatory authority for gaming on Indian lands, and the establishment of a National Indian Gaming Commission, are necessary to meet congressional concerns regarding gaming and to protect such gaming as a means of generating tribal revenue.

Section 11(b)(3) of IGRA provides that net revenues from any class II gaming activities conducted or licensed by any Indian tribe may be used to make per capita payments to members of the Indian tribe only if:

(A) the Indian tribe has prepared a plan to allocate revenues to uses authorized by section 11(b)(2)(B);

(B) the plan is approved by the Secretary of the Interior as adequate, particularly with respect to the uses described in clause (i) or (iii) of paragraph (2)(B);

(C) the interests of Minors and other legally incompetent persons who are entitled to receive any of the per capita payments are protected and preserved and the per capita payments are disbursed to the parents or legal guardian of such Minors or legal incompetents in such amounts as may be necessary for the health, education, or welfare of the Minor or other legally incompetent person under a plan approved by the Secretary and the governing body of the Indian tribe; and

(D) the per capita payments are subject to federal taxation and tribes notify members of such tax liability when payments are made.

On Date 1, the Tribe's General Council adopted and approved the Plan. The Plan was submitted to the Department of the Interior and on Date 2, the Bureau of Indian Affairs (BIA) Area Director approved the Plan pursuant to provisions of IGRA and

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the "Guidelines to Govern the Review and Approval of Per Capita Distribution Plans" issued by the Department of the Interior on December 21, 1992 (Guidelines).

The Plan provided for the Tribe's use of the net revenues which it had received and would receive from its Tribal gaming activities. Under the Plan, net gaming revenues would be allocated and used only for specific purposes, including to provide for the general welfare of the Tribe and its members in the form of per capita payments to all Tribal Members.

The Plan contained specific provisions, policies, and limitations relating to per capita payments which are summarized as follows:

Eligibility: All officially enrolled members of the Tribe, all persons eligible to vote in the last Tribal Council election, and all others, including Minors, recognized as eligible to be enrolled as members of the Tribe are eligible to receive per capita payments. Prior to each per capita distribution, a complete list of all eligible persons is prepared by the Enrollment Committee.

Deductions: Any debt owed to the Tribe by an eligible person is to be deducted from per capita payments until the debt is paid in full.

Notice regarding federal tax liability: Every per capita check will be accompanied by a notice that, under section 11(b)(3)(D) of IGRA, the payment is subject to federal income tax and it is the recipient's duty to report the income and pay any tax due on it. The Tribe will issue a Form 1099 to each recipient and file a copy with the Service. Upon request by the member, the Tribe will withhold tax from the member's check and remit it to the U.S. Treasury to that member's credit.

Method of payment to competent adults: All such payments to those who are legally competent and at least 18 years of age on the date of the proposed distribution will be made by a check payable to the competent adult in the name on the list of eligible persons prepared by the Enrollment Committee.

Method of payment for the benefit of Non-competent adults and Minors: Minors and Non-competent adults will not receive checks for per capita payments in the same manner as competent adults. Instead, the parent or legal guardian of a Minor or Non-competent adult may apply in writing, either before or after any proposed distribution, to the Tribal Council for all or such portion of that person's per capita distribution. The application must include a proposed budget of how the requested amount will be used for the health, education, or welfare of the Minor or Non-competent adult. The Tribal Council will act on the application and provide a written explanation of its decision. After a payment is made on behalf of a Minor or Non-competent adult, the parent or guardian is not eligible to receive another payment until and unless the Tribal Council receives an

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accounting of how the payment was spent, supported by receipts or other written evidence, together with a description of any differences between the proposed uses and the actual uses. Those who receive such checks will also receive a notice regarding federal tax liability.

Policy regarding payments for the benefit of Non-competent adults and Minors:

The Tribe's goal is that, subject to reasonable expenses for health, education, or welfare, as much as possible of a Minor or Non-competent adult's per capita entitlement will be available to be paid directly to them when they become adults or cease to be incompetent. Until then, all such unpaid entitlements will be separately accounted for, with an annual written statement to the Minor or Non-competent adult's parent or guardian, showing all approved expenditures, interest earned, and total balance. All such funds will be held in a separate insured account, not spent for any other purposes, and bear interest until paid directly to the Minor upon their reaching age 18 or to the Non-competent adult when they cease to be incompetent. At that time, a check will be issued directly to the individual entitled to the payment for the balance then due, including interest. To receive such a check(s), the recipient must sign a receipt for it and will receive a notice regarding tax liability.

Between Date 3 and Date 4, the Tribe's General Council adopted and approved an Amended Plan. The Amended Plan was submitted to the Department of the Interior and on Date 5, the BIA Area Director approved the Amended Plan pursuant to provisions of IGRA and the Guidelines.

The Plan was amended by the Tribe's General Council because the Tribe had received larger than anticipated gaming revenues and sought to protect Minors from the tax and other "undesirable consequences" of having their entire accumulated distributions, plus interest, distributed to them in one lump sum when they reach their eighteenth birthday.

The Amended Plan modified the initial Plan in several ways. First, the Amended Plan changed the lump-sum payment of principal and interest due on the Minor's eighteenth birthday to a series of payments beginning on the Minor's eighteenth birthday and ending on his or her thirtieth birthday. Second, the Amended Plan provided that if a Minor dies before reaching his or her eighteenth birthday, the accrued principal and interest belonging to the Minor will be paid in a lump sum to the Minor's parent or guardian. Third, the Amended Plan provides that a Minor's parents or guardians can direct the investment of amounts in the Minor's account. The Amended Plan did not change the provisions regarding per capita payments to Non-competent adults. Summarized below are the modifications to the Plan regarding payments to Minors that were added in the Amended Plan:

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Method of payment of accrued principal and interest to those who reach their eighteenth birthdays: When a Minor who is otherwise eligible to receive per capita payments, but who has not yet received all those payments because they have not yet reached their eighteenth birthday, becomes eighteen, payments of all unpaid accrued principal and interest otherwise due (in addition to that person's regular distributions) will be made, subject to the availability of funds due to such person, in annual installments commencing at age eighteen and ending at age thirty, by which time the entire unpaid accrued principal and interest otherwise due will have been paid.

The amounts paid will be increased, but never decreased, for increases in the cost of living each year. Federal income tax of 25% will automatically be withheld and paid to the Internal Revenue Service and a Form 1099 will be issued.<sup>1</sup>

If a Minor dies before reaching his or her eighteenth birthday, the accrued principal and interest belonging to said deceased Minor will be paid in one lump sum, subject to withholding for federal income tax, to the parent or legal guardian of the Minor.

If the payments made under this section are insufficient to adequately provide for the health, education, and welfare of a Tribal member who has reached eighteen, that person may apply to the Tribal Council which may increase the payments otherwise due. To receive such a check(s), the recipient must sign a receipt for it and will receive a notice regarding tax liability.

To the extent provided in the Trust Agreement between the Tribe and the Trustee, the parent or guardian of a Minor who is accruing principal and interest may direct the investments made by the Trustee, on behalf of the Minor.

On Date 6, the Tribal Chairman and the Trustee executed the Trust Agreement creating the Trust. The Preamble to the Trust Agreement provides that the Amended Plan requires that allocations of per capita distributions to the Beneficiaries not be distributed immediately but be retained by the Tribe for future distribution to such members or their parents, legal guardians or conservators in accordance with the terms of the Amended Plan; the amount and timing of per capita distributions to which the

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<sup>1</sup> We note that the Amended Plan provides that federal income tax of 25 percent will be withheld. The Amended Plan was approved by the BIA Area Director on Date 5, and the income tax withholding requirement of § 3402(r) is effective for payments made after December 31, 1994. Accordingly, beginning with 1995, any withholding required should be computed in accordance with the tables updated annually by the Internal Revenue Service.

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Beneficiaries are entitled are specified in the Amended Plan; the Tribe wishes to establish the Trust and to transfer to the Trust assets which shall be held therein, subject to the Tribe's creditors in the event of the Tribe's Insolvency, until paid to the Beneficiaries in such manner and at such times as specified in the Amended Plan, and it is the intention of the Tribe that the Trust shall constitute an unfunded arrangement and that contributions to the Trust shall provide the Tribe with a source of funds to meet its obligations to the Beneficiaries under the Amended Plan.<sup>2</sup>

Section 1(b) of the Trust Agreement provides that the Trust is irrevocable.

Section 1(d) of the Trust Agreement provides that the principal of the Trust, and any earnings thereon, shall be held separate and apart from other funds of the Tribe and shall be used exclusively for the uses and purposes of the Beneficiaries and general creditors subject to the conditions stated in the Trust Agreement. The Beneficiaries shall have no preferred claim on, or any beneficial ownership interest in, any assets of the Trust. Any rights created under the Amended Plan and the Trust Agreement shall be mere unsecured contractual rights of the Beneficiaries against the Tribe. Any assets held by the Trust will be subject to the claims of the Tribe's general creditors to the extent provided under applicable federal and state law in the event of Insolvency, as defined in section 3(a) of the Trust Agreement.

Section 3(a) of the Trust Agreement provides that the Trustee shall cease making distributions to the Trust Beneficiaries if the Tribe is Insolvent. The Tribe shall be considered Insolvent for purposes of the Trust Agreement if (i) the Tribe is unable to pay its debts as they become due, or (ii) the Tribe is subject to a pending proceeding as a debtor under the United States Bankruptcy Code, to the extent provided therein.

Section 3(b)(1) of the Trust Agreement provides that at all times during the continuance of the Trust, the principal and income of the Trust shall be subject to claims of general creditors of the Tribe as set forth in the Trust Agreement and to the extent provided by applicable federal and state law.

Section 3(b)(3) of the Trust Agreement provides that if at any time the Trustee has determined that the Tribe is Insolvent, the Trustee shall discontinue making distributions to the Trust Beneficiaries and shall hold the Trust assets for the benefit of the Tribe's general creditors to the extent of their interest under applicable federal and state law. Nothing in the Trust Agreement shall in any way diminish any rights of the

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<sup>2</sup> Although permitted by the Amended Plan, the Trust Agreement does not contain a provision allowing the parent or guardian of a Minor or Non-competent adult to direct investments. Instead, Section 5 of the Trust Agreement provides that the Trustee shall invest the amounts in the Trust under the direction of the Tribe or by any Trust beneficiary who is an adult.

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Trust Beneficiaries to pursue their rights as general creditors of the Tribe with respect to amounts due under the Amended Plan or otherwise.

Unlike the Trust Agreement, the Amended Plan does not include any provisions that would allow for the assets of the Trust to be paid to creditors of the Tribe if the Tribe becomes insolvent. The Agent's Statement of Facts in the Request for Technical Advice indicates that although the Plan and Amended Plan were approved by the BIA Area Director, there is no evidence the Trust Agreement was either submitted to or reviewed by the National Indian Gaming Commission or the Area Director of the BIA.<sup>3</sup> Neither the Tribal Council nor the General Council of the Tribe voted to approve the specific provisions of the Trust Agreement.

The Tribe earned revenues from class II gaming activities during Year 1 through Year 2, the years at issue. In each of these years, the Tribe transferred per capita distributions due Beneficiaries to the Trust pursuant to the Amended Plan. The Trustee has held these funds in a single pooled account, but has separately accounted for the contributions made for each Beneficiary. Each year, the Trustee has provided a written statement reporting approved expenditures, earnings, and balances held in the Trust to the parent(s) or guardian(s) of each Trust Beneficiary as required under the Plan and Amended Plan. No Beneficiaries of the Trust have died since its inception and there have been no non-Minor incompetent beneficiaries of the Trust. None of the per capita distributions or interest earned thereon were reported as income by the Trust Beneficiaries in Year 1 through Year 2, and the Tribe did not issue any Form 1099's to the Trust Beneficiaries for per capita distributions made to the Trust on their behalf.

#### LAW AND ANALYSIS:

Section 61 of the Code defines gross income as income from whatever source derived.

Section 451(a) and § 1.451-1(a) of the Income Tax Regulations provide generally that an item of gross income is includible in gross income for the taxable year in which actually or constructively received by a taxpayer using the cash receipts and disbursements method of accounting.

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<sup>3</sup> However, in a meeting held on Date 7, representatives of the BIA informed members of this office that even if approval of the Plan and the Amended Plan was given without a specific review of the terms of the Trust Agreement, the BIA would not overturn the original approval of the Plan and the Amended Plan. Accordingly, our analysis assumes that all provisions of the Trust Agreement are valid and are not inconsistent with any provisions of IGRA, including the provision in section 11(b)(3)(C), which requires that the interests of Minors and other legally incompetent persons entitled to receive per capita payments be protected and preserved.

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Under § 1.451-2(a) of the regulations, income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart, or otherwise made available so that the taxpayer may draw on it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

The doctrine of constructive receipt requires a cash basis taxpayer to recognize income when the taxpayer has an unqualified right to receive immediate payment. Ross v. Commissioner, 169 F.2d 483, 490 (1<sup>st</sup> Cir. 1948); Amend v. Commissioner, 13 T.C. 178, 185 (1949). In this case, the Trust's Beneficiaries are not in constructive receipt of funds placed in the Trust because they do not have an unqualified right to receive immediate payment of either the funds transferred to the Trust or income earned by the Trust. The Tribe placed the per capita distributions directly into the Trust and a Beneficiary cannot receive any distributions from the Trust prior to reaching his or her eighteenth birthday or receiving approval of the Tribal Council of an application submitted by the Beneficiary's parent or legal guardian.

In addition to the doctrine of constructive receipt, the facts of the case must be analyzed under the economic benefit doctrine, pursuant to which a taxpayer must include in gross income any economic or financial benefit derived from the absolute right to income in the form of a fund that has been irrevocably set aside for him in trust and is beyond the reach of the payor's creditors. For example, in Sproull v. Commissioner, 51 T.C. 244 (1951), aff'd per curiam, 194 F.2d 541 (6<sup>th</sup> Cir. 1952), the court held that the amount placed in trust to be paid out to the taxpayer in later years conferred an economic benefit on the petitioner in the year the trust was funded. In that case, the taxpayer, a corporation president, voluntarily decreased his compensation. In a later year, when the corporation was sound financially, a trust was set up by the board of directors for the benefit of the taxpayer. In determining that funding the trust conferred an economic benefit on the taxpayer in the year the trust was established, the court noted that the employer had relinquished all control, the taxpayer had an absolute right to the funds that were placed in trust and were to be applied for his sole benefit, the taxpayer's right to the funds was not contingent, there were no restrictions on the taxpayer's right to assign or otherwise dispose of his interest, and the funds were beyond the reach of the employer's creditors.

The economic benefit doctrine has also been applied to require inclusion in income of prize winnings when they are irrevocably placed in a fund to be paid to the winner at a later date. See Pulsifer v. Commissioner, 64 T.C. 245 (1975); Anastasio v. Commissioner, 67 T.C. 814 (1977); Rev. Rul. 62-74, 1962-1 C.B. 68; Rev. Rul. 67-203, 1967-1 C.B. 105.

Rev. Rul. 83-25, 1983-1 C.B. 116, holds that a minor received the economic benefit of a trust when it was established by court order to receive damages awarded to the minor as a result of a personal injury suit. Under the terms of the trust, the trustee

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was authorized to distribute funds necessary for the health, education, support, or maintenance of the minor. The trust was not subject to revocation by the minor, but was subject to amendment, modification, or revocation by the court. The trust was to terminate upon the minor reaching the age of 21, at which time the trust would distribute all of its property to him. If the minor died before reaching the age of 21 the trust property would pass to the minor's estate.

The economic benefit doctrine does not apply where the beneficiary's ability to obtain trust amounts are subject to a future condition or forfeiture. For example, the court in Drysdale v. Commissioner, 277 F.2d 413 (6<sup>th</sup> Cir. 1960), held that the taxpayer did not receive an economic benefit from a trust established by his employer since the taxpayer was restricted by the terms of the trust from exercising any dominion over the funds.

In the instant case, Section 1(d) of the Trust Agreement provides the Beneficiaries shall have no preferred claim on, or any beneficial ownership interest in, any assets of the Trust. Any rights created under the Amended Plan and the Trust Agreement shall be mere unsecured contractual rights of the Beneficiaries against the Tribe. Any assets held by the Trust will be subject to the claims of the Tribe's general creditors to the extent provided under applicable federal and state law in the event of the Tribe's insolvency. Thus, the Beneficiaries will not receive an economic benefit requiring inclusion of amounts in income upon the funding of the Trust or as income is earned on amounts in the Trust. Instead, the accumulated per capita distributions and the related income are taxable to the Beneficiaries upon actual receipt of distributions from the Trust.

Section 671 of the Code provides that where a grantor shall be treated as the owner of any portion of a trust under subpart E, part I, subchapter J, chapter 1 of the Code, there shall be included in computing the taxable income and credits of the grantor those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust (to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against tax of an individual).

Section 677(a)(2) provides that the grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be held or accumulated for future distribution to the grantor.

Section 1.677(a)-1(d) of the regulations provides that under § 677, a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor.

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Because the principal and income of the Trust may be applied in discharge of legal obligations of the Tribe, the Tribe is treated as the owner of the Trust under § 677. Accordingly, the annual earnings of the Trust are not gross income of the Beneficiaries. The Tribe, which is not subject to federal income tax, shall not be subject to federal income tax on the income of the Trust. Rev. Rul. 94-16, 1994-1 C.B. 19; Rev. Rul. 67-284, 1967-2 C.B. 55.

Section 3402(r) provides that every person, including an Indian tribe, making a payment to a member of an Indian tribe from the net revenues of any class II or class III gaming activity conducted or licensed by such tribe, shall deduct and withhold from such payment a tax in an amount equal to such payment's proportionate share of the annualized tax. This provision is effective for payments made after December 31, 1994.

Although § 3402(r) does not contain provisions regarding the timing of the withholding requirement, the legislative history, in setting forth Congress' reasons for adding § 3402(r) to the Code, provides some guidance. While Indian tribes may distribute net revenues from gaming activities to tribal members as per capita distributions, these distributions are taxable to the tribal members. As the legislative history explains:

Establishing withholding on such payments will more closely match estimated tax payments to ultimate tax liability. For some tribal members, this change may eliminate the need to make quarterly estimated tax payments. For others, it will reduce the likelihood that they will face penalties for underpayment of tax at the time of tax filing.

H.R. Rep. No. 826, 103d Cong., 2d Sess., pt. 1, at 170-171 (1994). The idea in enacting § 3402(r) was to collect income taxes on taxable payments at the payment source, in order to more closely match estimated tax payments to ultimate tax liability. Withholding income tax from payments that will not result in tax liability for the year does not comport with the Congressional intent. Rather, income tax should be withheld in the year in which the per capita distributions are includible in gross income under § 61. Thus, the § 3402(r) withholding requirement applies at the time amounts are distributed from the Trust, rather than upon the funding of the Trust.

A copy of this technical advice memorandum is to be given to the Tribe. Section 6110(k)(3) provides that it may not be used or cited as precedent.