

# TaxClinic

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## PRACTICAL ADVICE ON CURRENT ISSUES

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#### DEPRECIATION

### Electing to Accelerate AMT and Research Credits in Lieu of Bonus Depreciation

The Housing Assistance Tax Act of 2008, P.L. 110-289 (Housing Act), allows corporations to make an election to forgo bonus depreciation and instead claim an accelerated pre-2006 research and/or AMT credit. According to the act, if a corporation purchases and places in service qualified Sec. 168(k) bonus depreciation property after March 31, 2008, and before January 1, 2009 (January 1, 2010, for long production period property, transportation property, and certain aircraft), it may make an election under Sec. 168(k)(4) to not claim the 50% additional first-year bonus depreciation. Instead it may claim a refundable credit for a portion of its unexpired and unused research and/or AMT credit attributable to tax years beginning before January 1, 2006.

The American Recovery and Reinvestment Act of 2009, P.L. 111-5 (ARRA), generally extends bonus depreciation for another year. Correspondingly, the Sec. 168(k)(4) election is also amended by ARRA and is extended to “extension property.” To clarify the implementation of these changes, the IRS issued Rev. Proc. 2009-33, which provides guidance on qualified property eligible for extension, time and manner requirements for making the election, and computation of the increased amount of research and AMT credits for taxpayers who did or did not elect accelerating credits prior to ARRA.

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## Extension Property

The Housing Act allows taxpayers to elect to accelerate AMT and research credits instead of taking bonus depreciation for new property that is (1) depreciable under a modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less, (2) MACRS water utility property, (3) off-the-shelf computer software depreciable over three years, or (4) qualified leasehold improvement property. The taxpayer must have purchased the property after March 31, 2008, and placed it in service before January 1, 2009. In the case of property having longer production periods, transportation property, and certain aircraft, the original use must begin before January 1, 2010.

ARRA generally extends the placed-in-service date from January 1, 2009, to January 1, 2010 (and January 1, 2011, in the case of long production period property, transportation property, and certain aircraft). As a result, extension property, as defined by Sec. 168(k)(4)(H)(iii), is Sec. 168(k) property acquired after March 31, 2008, and placed in service during calendar year 2009 (2010 in the case of long production property, transportation property, and certain aircraft). The bonus depreciation amount, maximum increase amount, and maximum amount are calculated separately for eligible qualified property that is extension property and for eligible qualified property that is not extension property.

## Bonus Depreciation Amounts, Maximum Increase Amounts, and Maximum Amounts

Under Rev. Proc. 2008-65, the bonus depreciation amount is 20% of the difference between:

- The aggregate amount of bonus and regular depreciation that would be allowable for eligible qualified property if the 50% additional first-year depreciation applied; and
- The aggregate amount of depreciation that would be allowable for eligible qualified property if the 50% additional first-year depreciation did not apply to all such property.

The bonus depreciation is limited to the maximum increase amount, which is the

lesser of (1) \$30 million or (2) 6% of the unexpired and unused pre-2006 research and AMT credit carryforwards to the current tax year. The bonus depreciation is further limited to the maximum amount, which is the maximum increase amount less the bonus depreciation amount claimed for all prior years.

## Election Not to Apply Sec. 168(k)(4) to Extension Property

If a corporation has made the Sec. 168(k)(4) election for its first tax year ending after March 31, 2008, it may elect to not apply Sec. 168(k)(4) to extension property placed in service in its first tax year ending after December 31, 2008, and in any subsequent year. Even if the taxpayer does not have any extension property during its first tax year after December 31, 2008, the taxpayer must make the election to not apply Sec. 168(k)(4) to extension property if the taxpayer wishes to apply the election to extension property placed in service in subsequent years.

To make the election, the taxpayer must attach a statement indicating that it is making the election not to apply Sec. 168(k)(4) to extension property by the due date (including extension) of the federal income tax return for the taxpayer's first tax year ending after December 31, 2008.

## Rev. Proc. 2009-33

Rev. Proc. 2009-33 provides the following example to illustrate how the bonus depreciation amount, maximum increase amount, and maximum amount are calculated for extension property and for eligible qualified property that is not extension property.

**Example:** *B Corp.* is a calendar-year taxpayer. During 2008 and 2009, it purchases and places in service three properties: (1) property X, purchased and placed in service on August 1, 2008, with a cost of \$50 million; (2) property Y, production of which begins on September 1, 2009, completed and placed in service on October 1, 2009, with a cost of \$100 million; and (3) property Z, purchased and placed in service on August 1, 2009, with a cost of \$50 million.

*B* depreciates all the properties using the 200% declining balance method, a five-year recovery period, and the half-year convention. *B* files its original 2008 and 2009 tax returns on March 15, 2009 and 2010, respectively. *B* makes a Sec. 168(k)(4) election on its 2008 tax return and does not make the election not to apply Sec. 168(k)(4) to extension property on its 2009 tax return. As of December 31, 2008, *B* has \$300 million in research and AMT credit carryforwards from tax years before 2006.

For *B*'s tax year ending December 31, 2008, X is eligible qualified property. As a result of the Sec. 168(k)(4) election, the bonus depreciation amount is 20% of \$20 million, or \$4 million. Because the \$4 million is less than \$30 million and 6% of *B*'s pre-2006 research and AMT credit carryover (6% × \$300 million, or \$18 million), *B* is not limited by the maximum increase amount. Therefore, *B* claims \$4 million of refundable credits for its tax year ending December 31, 2008.

For tax year 2009, Y is eligible qualified property that is not extension property. As a result of *B*'s Sec. 168(k)(4) election, Y is taken into account in computing the bonus depreciation for this tax year. Z is extension property. Because *B* did not make the election not to apply Sec. 168(k)(4) to extension property, a separate bonus amount, maximum increase amount, and maximum amount are calculated for Z. The bonus depreciation amount for Y is 20% of \$40 million, or \$8 million. The maximum increase amount is \$18 million (the lesser of \$30 million or 6% of the \$300 million pre-2006 research and AMT credit). The maximum amount is \$14 million (\$18 million less the \$4 million of the prior year's bonus depreciation for eligible qualified property that is not extension property).

Because \$8 million is less than \$14 million, *B* may claim \$8 million of its refundable credit attributable to eligible qualified property that is not extension property for its 2009 tax year. The bonus depreciation amount for Z is 20% of \$20 million, or \$4 million. *B*'s maximum increase amount is \$18 million. *B*'s maximum amount for extension property is

\$18 million. Because \$4 million is less than \$18 million, B may claim \$4 million of refundable credits attributable to extension property for its 2009 tax year.

## Conclusion

ARRA extends the election to accelerate research and AMT credits in lieu of bonus depreciation to extension property. If a corporation has extension property, it may consider whether to make an election to apply to its extension property. If a corporation has previously made such an election and does not elect not to apply the election to extension property, separate bonus depreciation, maximum, and maximum increase amounts should be computed and applied, both to eligible qualified property, which is extension property, and to eligible qualified property, which is not extension property, as explained in Rev. Proc. 2009-33.

From Anne Chang, CPA, Irvine, CA

## EXEMPT ORGANIZATIONS

### Small Tax-Exempt Organization E-Postcard Requirements Finalized

The Pension Protection Act of 2006, P.L. 109-280, made various modifications to the provisions governing tax-exempt organizations. Among the changes was the addition of a new notification requirement under Sec. 6033(i) for small tax-exempt organizations that are not required to file an annual information return under Sec. 6033(a)(1). While the final regulations under Regs. Sec. 1.6033-6 (T.D. 9454), which were released on July 23, 2009, did not materially change the temporary regulations that they replaced, it is prudent to note a provision, which will come into play for the first time in tax year 2009, that may jeopardize the tax-exempt status of some small organizations that fail to comply with the notification requirement.

### Notification Requirement

As described in Sec. 6033(i), the notification requirement is an electronic form that must be submitted annually. The form to be submitted is Form 990-N, Electronic Notice (e-Postcard) for Tax-

Exempt Organizations Not Required to File Form 990 or 990-EZ.

The form asks organizations to provide the following basic information:

- Legal name;
- Any name under which the organization operates or does business;
- Mailing address;
- Internet address (if any);
- Taxpayer identification number;
- Name and address of a principal officer;
- Evidence of the continuing basis for the organization's exemption from annual filing (verification of continuing gross receipts of \$25,000 or less); and
- Notification if the organization has terminated.

The filing date of the e-postcard is the fifteenth day of the fifth month after the close of the organization's tax year. It should be submitted at <http://epostcard.form990.org>. No filing fee is required.

### Organization Required to File

Generally, tax-exempt organizations are required to file either a Form 990, Return of Organization Exempt from Income Tax, or the shorter Form 990-EZ annually. However, two provisions of Sec. 6033 serve to reduce the filing burden placed on smaller exempt organizations.

The first of these provisions, Sec. 6033(a)(3)(A)(ii), specifically exempts various described organizations, with gross receipts generally not more than \$5,000, from the requirement to file a Form 990. However, the second provision, a discretionary exemption set by the IRS under the authority allotted to it under Sec. 6033(a)(3)(B), is more inclusive, providing an exemption to organizations with gross receipts that are normally \$25,000 or less (Rev. Proc. 94-17). The organizations that benefit from the \$25,000 minimum gross receipts exemption are required to file the e-postcard.

If an organization is required to file an annual Form 990, Form 990-EZ, or Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation, it is not required to also file an e-postcard. Churches and organizations that are included in a group return

are also not required to file an e-postcard. If an organization is required to file an e-postcard, it may choose to file a complete Form 990 or Form 990-EZ instead and thereby will be deemed to have fulfilled its filing requirement. This provision of the regulations provides organizations uncomfortable with the statutorily required electronic submission a means by which to file in a paper format.

### Penalty for Failure to File

The e-postcard requirement appears to be a way of ensuring that IRS records of contact information for tax-exempt organizations remain current and of providing public access to the information. Limited information for organizations eligible to receive tax-deductible charitable contributions, such as name, city, and state, is made available to the public via Publication 78, *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986*, located at [www.irs.gov/eo](http://www.irs.gov/eo) (under the "Search for Charities" link). However, e-postcards in their entirety may be searched for and viewed at [www.irs.gov/app/ePostcard](http://www.irs.gov/app/ePostcard).

There is no monetary penalty for late filing or failing to file an e-postcard. However, under Sec. 6033(j), an organization that fails to file for three consecutive years will have its tax-exempt status revoked as of the due date of the third missed filing. Therefore, because the e-postcard requirement became effective starting with tax years beginning after 2006, organizations that have been in existence since at least that time and have failed to file to date will find that their tax-exempt status will be revoked during 2010 if they do not timely submit their e-postcard for the 2009 tax year.

From Sarah Lovinger, Irvine, CA

## EXPENSES & DEDUCTIONS

### New Rules Seek to Clarify Allocation and Reporting of Mortgage Insurance Premiums

Many providers of mortgage insurance were severely affected by the housing crisis, resulting in a general increase in mortgage insurance premiums. The IRS recently issued temporary regulations that

explain how to properly determine the deductible amount of mortgage insurance premiums (T.D. 9449). These newly issued regulations describe how to calculate the amount of prepaid qualified mortgage insurance premiums that may be treated as qualified residence interest for each tax year under Sec. 163(h)(4)(F). The temporary regulations provide guidance to reporting entities receiving premiums, including prepaid premiums, for mortgage insurance and reflect changes to the law made by the Tax Relief and Health Care Act of 2006, P.L. 109-432, and the Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142.

In general, the new provisions treat certain qualified mortgage insurance premiums as qualified residence interest. This treatment applies only to certain qualified mortgage insurance premiums paid or accrued on or after January 1, 2007, and on or before December 31, 2010, on mortgage insurance contracts issued on or after January 1, 2007.

### Sec. 163 and Qualified Mortgage Insurance Premiums

Mortgage insurance premiums are deductible as qualified mortgage interest if the premiums are paid or accrued in connection with acquisition indebtedness for a qualified residence.

Sec. 163(h)(4)(E) defines qualified mortgage insurance as:

- Mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration; and
- Private mortgage insurance (as defined by Section 2 of the Homeowners Protection Act of 1998, P.L. 105-216 (12 U.S.C. §4901), as in effect on December 20, 2006).

The amount treated as qualified residence interest is reduced under Sec. 163(h)(3)(E)(ii) by 10% for each \$1,000 (\$500 in the case of a married individual filing a separate return) that the taxpayer's adjusted gross income exceeds \$100,000 (\$50,000 in the case of a married individual filing a separate return).

Mortgage insurance premiums are amortized annually by allocating the premiums to a capital account and treating them

as paid in the periods to which the amount is allocated. However, no deduction is allowed for the unamortized balance of the account if the mortgage is satisfied before the end of its term. Importantly, the allocation rules do not apply to amounts paid for qualified mortgage insurance provided by the Veterans Administration or the Rural Housing Administration. In addition, Sec. 163(h)(3)(E)(iv)(II) disallows a deduction for amounts allocable to any period after December 31, 2010.

### Information Return Requirement for Persons Receiving Mortgage Insurance Premiums

Section 419 of the 2006 Tax Relief and Health Care Act also added Sec. 6050H(h) to the Code, which provides that any person who, in the course of a trade or business, receives from an individual premiums for mortgage insurance aggregating \$600 or more for any calendar year must file a Form 1098, Mortgage Interest Statement.

### Temporary Regs.

The temporary regulations generally adopt rules that had been issued in Notice 2008-15. They offer guidance to individual taxpayers in determining the amount of prepaid qualified mortgage insurance premiums that can be treated as qualified residence interest under Sec. 163(h)(3)(E) and that may be deducted. The regulations also offer guidance to reporting entities receiving premiums, including prepaid premiums, for mortgage insurance. They provide that an individual taxpayer may allocate the prepaid premium ratably over the shorter of (1) the stated term of the mortgage or (2) 84 months, beginning with the month in which the insurance was obtained (Temp. Regs. Sec. 1.163-11T). The temporary regulations also provide that reporting entities receiving mortgage insurance premiums of \$600 or more during a calendar year from an individual taxpayer must report the amount of all mortgage insurance premiums, including prepaid mortgage insurance premiums, received during that year (Temp. Regs. Sec. 1.6050H-3T).

Whether a person receives \$600 or more of mortgage insurance premiums is

determined on a mortgage-by-mortgage basis. A recipient need not aggregate mortgage insurance premiums received on all an individual's mortgages to determine whether the \$600 threshold is met. Therefore, a recipient need not report mortgage insurance premiums of less than \$600 received on a mortgage, even though it receives a total of \$600 or more of mortgage insurance premiums on all the mortgages for an individual for a calendar year.

### Conclusion

The housing crisis has affected mortgage insurance premiums. Allowing such premiums to be amortized and deducted as mortgage interest provides some relief to affected taxpayers. These temporary regulations add clarity to the process of determining the amount of the prepaid premium that is treated as qualified residence interest each tax year, and they also provide guidance to reporting entities receiving premiums, both regular and prepaid, for mortgage insurance.

From John A. Eckweiler, CPA, Irvine, CA

### Proposed Procedures for Simplifying Employer-Provided Cell Phone Substantiation Rules

In June 2009 the IRS published Notice 2009-46, requesting comments on several proposed procedures for simplifying the substantiation and reporting requirements of employees' personal use of employer-provided cellular telephones.

Under the current provisions of the Code and regulations, employees must substantiate, for each separate use of their employer-provided cell phones, the cost, date, and business purpose of the telephone's use. An employee's failure to comply with the substantiation requirements in a timely manner may result in the inclusion of the full fair market value (FMV) of the employer-provided cell phone in the employee's gross income without an exclusion for business-related uses.

### Background

Congress added Sec. 280F to the Code with the enactment of the Deficit Reduction Act of 1984, P.L. 98-369. The intent

of Sec. 280F was to identify certain personal property items that were acquired for business use but inherently lent themselves to personal use. The enumerated property, defined as listed property in Sec. 280F(d)(4), originally included passenger automobiles, computer equipment, and other property generally used for transportation, entertainment, and recreation. Congress added cellular telephones to the definition of listed property with the enactment of the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239.

While the provisions of Sec. 280F identify and generally limit the use of accelerated depreciation for listed property, a companion provision, Sec. 274(d)(4), which also became law under the Deficit Reduction Act of 1984, prohibits *any* deduction or credit with respect to any listed property as defined by Sec. 280F(d)(4), unless certain substantiation and record-keeping requirements are met by the taxpayer. Congress's intent with the codification of these measures was to tax the personal-use component of those specific property items identified in Sec. 280F(d)(4).

Twenty years ago, cell phones were relatively bulky and prohibitively expensive for most taxpayers. Use of cell phones was not widespread, and Congress did not envision their pervasive use in today's business environment. Over the past two decades, technology and competition have reduced the size and cost of cell phones as well as their monthly service cost. Cell phones featuring internet and e-mail access, instant messaging, cameras, and GPS navigation have facilitated the extension of the workplace to almost anywhere and have effectively stretched the length of the workday to 24 hours. However, the substantiation and record-keeping provisions of Sec. 274(d)(4) have not kept pace with the cell phone's role in today's business environment, where the administrative burden of complying with the substantiation provisions of Sec. 274(d)(4) is disproportionate to the low operating cost and the pervasive use of the cell phone.

Many members of Congress have recognized the burdensome administrative cost of the existing substantiation and

record-keeping provisions with respect to business cell phone use. In 2008 several bills were introduced in both the House and the Senate that would have either removed cell phones from the definition of listed property or ameliorated the burdensome substantiation requirements. None of the bills has become law.

In this context, Douglas Shulman, the IRS commissioner, expressed support for easing the substantiation requirements earlier this year and urged Congress to "make clear that there will be no tax consequence to employers or employees for personal use of work-related devices such as cell phones provided by employers" ([www.irs.gov/newsroom/article/0,,id=209795,00.html](http://www.irs.gov/newsroom/article/0,,id=209795,00.html)).

### Notice 2009-46

The stated purpose of Notice 2009-46 was to solicit comments from the public regarding three proposed simplified methods of substantiating employees' business use of employer-provided cell phones, in addition to methods of determining the FMV of any taxable fringe benefit that accrues to employees for their personal use of employer-provided cell phones.

### Simplified Substantiation Methods

The three proposed simplified substantiation methods listed in Notice 2009-46 are:

- A minimal personal-use method with two variants;
- A safe-harbor substantiation method; and
- A statistical sampling method.

Both variants of the minimal personal-use method would allow employers to deem all an employee's use of an employer-provided cell phone as business use. Under the first variant, the employee would be required to provide the employer with sufficient records to establish that the employee maintains and uses a personal cell phone for personal use during business hours. The alternative minimal personal-use method proposed in Notice 2009-46 adopts a *de minimis* approach in which a certain amount of personal use would be disregarded and the entire amount of cell phone use would be deemed business use. The notice does not specify the amount that would be considered minimal

personal use but suggests that the amount would be determined by a set number of allowable personal-use minutes.

Under the safe-harbor substantiation method, a flat percentage of each employee's use of an employer-provided cell phone would be deemed as business use. The balance would be treated as personal use. In Notice 2009-46, the IRS and Treasury proposed a safe-harbor business use percentage of 75%.

Both variants of the minimal personal-use method, as well as the safe-harbor substantiation method, would significantly reduce the substantiation and record-keeping burden of employers and employees alike. However, the *de minimis* approach would still require a certain amount of record keeping to determine whether the *de minimis* number of minutes had been exceeded.

The third simplified substantiation method enumerated in Notice 2009-46, the statistical sampling method, would allow employers to use statistical sampling techniques to determine an employee's personal use of an employer-provided cell phone. Notice 2009-46 provides that methodologies similar to those outlined in Rev. Proc. 2004-29 (used to establish a taxpayer's substantiated expenses paid or incurred for meals and entertainment that are not subject to the 50% deduction limitation) may be used to establish personal cell phone use. The remaining portion would be deemed business use.

Sampling methods have been available to taxpayers since 1986 but apparently have fallen short in addressing the simplification issue for employers providing cell phones to a large number of employees. Temp. Regs. Sec. 1.274-5T(c)(3)(ii)(A), effective for tax years beginning on or after January 1, 1986, provides that sampling may be employed to substantiate the business use of listed property. However, the sampling methodologies suggested in the examples cited in Temp. Regs. Sec. 1.274-5T(c)(3)(ii)(C) are more applicable to small businesses because they would require sampling for periods for each employee rather than sampling from the entire employee population. Rev. Proc. 2004-29 provides very specific guidance as to what sampling applications a taxpayer

may use, including sampling techniques, population size, and others. Calculation of confidence limits is also required.

### Determining FMV of Personal Use

To the extent any employer-provided cell phone use is not substantiated business usage, which would make it excludible from the employee's gross income as a working condition fringe benefit, the FMV of the cell phone use is included in the employee's gross income. Because the cost incurred by the employer is not determinative of the FMV of a fringe benefit under Regs. Sec. 1.61-21(b)(2), the IRS and Treasury have expressed interest in understanding the methods employers were using to determine the FMV to the employee of employer-provided cell phones.

### Conclusion

With the increasing utility and decreasing costs of cell phones, they have become an integral component of business communications. When cell phones were first included in the listed property and subjected to stringent substantiation and record-keeping requirements, they were relatively costly and novel items. However, today their use has become pervasive, which means that the burden of substantiating the business use of cell phones and maintaining records as required under the current tax laws has increased relative to the cost of the cell phone use. The fact that members of Congress and the IRS have recognized the problem, and that the IRS has taken steps to remedy the issue by suggesting simplified methods and seeking public comment, will hopefully mean that more reasonable methods for determining business versus personal use as well as FMV are on the horizon.

From Michael Coley, MST, CPA, Irvine, CA

#### FOREIGN INCOME & TAXPAYERS

### FBAR Extended for Certain Persons

Any U.S. person who has a financial interest in or signature authority over foreign bank accounts, the maximum value of which in aggregate is over \$10,000 at any

time during a year, must file a Form TD F 90.22-1, Report of Foreign Bank and Financial Accounts (FBAR), by June 30 of the following year. Recent changes to the FBAR instructions had left taxpayers and practitioners with questions about who is required to file the form.

### Signature Authority

One area of confusion involves those who have signature authority over, but no financial interest in, these types of accounts. According to the FBAR instructions, "A person has signature authority over an account if such person can control the disposition of money or other property in it." This covers anyone who can sign a check or instruct a wire transfer from a foreign account.

Such a definition would include the finance department of a company that has foreign accounts. Often the controller or head of the finance department of a U.S. company can sign checks or otherwise make transfers but has no actual foreign interest. This led practitioners to question whether every controller (or other person with signature authority over a company's accounts) that is a U.S. person must file the FBAR, even if it is simply a function of his or her employment, and even though the company would already file one on those same accounts.

### Commingled Funds

There is also confusion as to whether an owner of a commingled fund, such as a mutual fund, that has foreign holdings should file the FBAR. The FBAR instructions note that the term "financial account" includes assets that are held "in a commingled fund, and the account holder holds an equity interest in the fund (including mutual funds)."

A mutual fund may have a mix of foreign and domestic holdings. This led practitioners to question whether an account owner that has more than \$10,000 in mutual funds must investigate every mutual fund to determine the fair value of domestic and foreign holdings within the fund.

### Notice 2009-62

Because of this confusion, the IRS was concerned that some persons in the above

situations may have missed the June 30, 2009, FBAR filing deadline. To give itself time to address these issues, in early August the IRS released Notice 2009-62, which extends the time for filing an FBAR for those in the above situations. The notice allows up to June 30, 2010, to file an FBAR for any calendar year from 2008 and earlier for those persons with (1) "signature authority over, but no financial interest in, a foreign account" or (2) "a financial interest in, or signature authority over, a foreign commingled fund."

At the same time, the notice invited comments over future regulations related to the above two types of account holders.

From Ali Allison, CPA, MST, Los Angeles, CA

### Treatment of Foreign Currency Option Gains

As many practitioners know, Sec. 988 treats most (but not all) gains and losses from foreign currency transactions as ordinary in character. Depending on the taxpayer's circumstances, this treatment can be favorable or otherwise.

While the full range of exceptions to this rule is beyond the scope of this item, there is one that may be of particular interest to investors.

*Example:* Individual U.S. investor *K* holds substantial foreign stocks (on the London Stock Exchange) denominated in foreign currency. *K* is concerned about possible fluctuations in the U.S. dollar/U.K. pound exchange rate and decides to manage that risk by purchasing a foreign currency option directly from a U.S. investment bank (see the exhibit on p. 741).

In this example, *K* pays \$15,000 for the right to receive (in cash) the net value of the excess of the U.S. dollar (USD) amount over the U.K. pound (GBP) amount on the valuation date. If there is no net positive excess, no additional money changes hands.

More specifically, if on the valuation date the spot exchange rate is 1.6 USD/GBP (i.e., the value of the USD has

## Exhibit: Details of foreign currency option in the example

- European-style GBP put/USD call, with nondeliverable settlement
- Not exchange traded (or subject to the rules of an exchange)
- Call currency amount: \$650,000
- Put currency amount: £345,000
- Strike price: 1.8841 USD/GBP
- Reference currency: GBP
- Settlement currency: USD
- Trade date: January 2, year 1
- Valuation date: December 1, year 1
- Premium: \$15,000

increased compared with the GBP), *K* would be entitled to receive \$650,000 – (£345,000 × 1.6 USD/GBP) = \$98,000. After consideration of the option premium, *K*'s net profit would be \$83,000.

**Query:** Should this profit be characterized as ordinary income or capital gain? If the latter, what is the holding period? While the answer might seem clear at the outset, getting there is somewhat circuitous and may also require specific action on *K*'s part in the form of an election by the end of the trade date.

### Sec. 988

In general, Sec. 988 treats foreign currency gains and losses attributable to a Sec. 988 transaction as ordinary income or loss. Moreover, by its express terms, Sec. 988 overrides any other contrary provisions under chapter 1 of the Internal Revenue Code (Secs. 1–1400U-3, dealing with normal taxes and surtaxes). However, exceptions do apply.

In determining whether a particular arrangement is covered by this rule, Sec. 988(c)(1) treats as a Sec. 988 transaction any specified transaction (e.g., any forward contract, futures contract, option, or similar financial instrument) if the amount the taxpayer is entitled to receive (or is required to pay) by reason of the transaction is determined by reference to the value of one or more nonfunctional currencies. Because the option in this example meets those criteria, it would appear (so far) to constitute a Sec. 988 transaction and presumably give rise to ordinary income.

### Interplay with Sec. 1256

Next, consider Sec. 988(c)(1)(D), which provides that the acquisition of any forward contract, futures contract, option, or similar financial instrument is not a Sec. 988 transaction if it represents a regulated futures contract or nonequity option that would be marked to market under Sec. 1256 if held on the last day of the tax year.

Under Sec. 1256(g)(1), a regulated futures contract is a contract for which the amount required to be deposited and the amount that may be withdrawn depend on a system of marking to market and that is traded on or subject to the rules of a qualified board or exchange. In the above example, the option is clearly not a regulated futures contract because no amounts were required to be deposited or able to be withdrawn.

Under Sec. 1256(g)(3), a nonequity option includes any listed option that is not an equity option. Sec. 1256(g)(5), in turn, provides that a listed option is one that is traded on (or subject to the rules of) a qualified board or exchange. Sec. 1256(g)(7) further provides that the term “qualified board or exchange” means (1) an SEC-registered national securities exchange; (2) a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission; or (3) any other exchange, board of trade, or other market that Treasury determines has rules adequate to carry out the purposes of Sec. 1256.

While this statutory language is less definitive than some might like, the IRS has

provided guidance in identifying certain entities as qualified boards of exchange for purposes of Sec. 1256. Nevertheless, in the example, the foreign currency option was not traded on (or subject to the rules of) an exchange of any sort. Consequently, the option should not constitute a nonequity option.

As a result, the option should not be excluded from consideration as a Sec. 988 transaction by Sec. 988(c)(1)(D). It would continue to appear (so far) to constitute a Sec. 988 transaction and presumably give rise to ordinary income/loss.

### Election to Treat as Capital Gain/Loss

Having established the option as a Sec. 988 transaction, one of the exceptions to ordinary income/loss treatment is found in Sec. 988(a)(1)(B), which permits taxpayers to elect to treat gains/losses on certain foreign currency arrangements as capital in nature. This exception provides that (unless prohibited in the regulations), among other things, a taxpayer may elect to treat any foreign currency gain or loss attributable to an option that is a capital asset in the hands of the taxpayer and that is not a part of a straddle as capital gain or loss if the taxpayer makes an election and identifies the transaction before the close of the day on which such transaction is entered into (or earlier, as Treasury may prescribe).

**Capital asset characterization:** In relevant part, Sec. 1221(a) provides the definition of a capital asset as property held by a taxpayer, but it excludes:

- Any commodities derivative financial instrument held by a commodities derivatives dealer; and
- Any hedging transaction that is clearly identified as such before the close of the day on which it was entered into (or such other time as Treasury may by regulations prescribe).

With respect to the first item, the investor is not a “commodities derivatives dealer” because he or she is not a person that regularly offers to enter into, assume, offset, assign, or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business (Sec. 1221(b)(1)(A)).

As for the second item, the option is not a hedging transaction because it was not a transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily:

- To manage risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer;
- To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or
- To manage such other risks as Treasury may prescribe in regulations (Sec. 1221(b)(2)).

Accordingly, because the option does not meet any of the exceptions in Sec. 1221(a), it is a capital asset and eligible for the aforementioned election.

**Mechanics of election:** Regs. Sec. 1.988-3(b) addresses the requirements of making the Sec. 988(a)(1)(B) capital gain/loss election. The requirements for that election are as follows:

- The taxpayer makes the election by clearly identifying the transaction in his or her books and records on the date he or she enters into the transaction. While no specific language or account is necessary for identifying a transaction, the taxpayer must consistently apply the method of identification and must clearly identify the particular transaction subject to the election.
- The taxpayer must provide verification of the election by attaching a statement to his or her income tax return that sets forth: (1) a description and the date of each election made by the taxpayer during the tax year; (2) a statement that each election made during the tax year was made before the close of the date the transaction was entered into; (3) a description of any contract for which an election was in effect and the date such contract expired or was otherwise sold or exchanged during the tax year; (4) a statement that the contract was never part of a straddle as defined in Sec. 1092; and (5) a statement that all transactions subject to the election are included on the statement attached to the taxpayer's income tax return.

**Observation:** Taxpayers that do not comply with these requirements run the risk of having the IRS invalidate the election. However, if the failure was due to reasonable cause or a bona fide mistake, taxpayers may be able to obtain relief regarding that failure, but they have the burden of proving that they are entitled to relief. Fortunately, Regs. Sec. 1.988-3(b)(5) provides a way for most taxpayers to obtain a presumption of having met the statement and verification requirements by getting independent verification. Taxpayers may get this verification by (1) establishing a separate account (or accounts) with an unrelated broker or dealer through which all transactions to be independently verified are conducted and reported; (2) having only those transactions entered into on or after the date the taxpayer establishes the account be recorded in the account; (3) having transactions subject to the election entered into the account on the date the transactions are entered into; and (4) obtaining from the broker or dealer a statement detailing the transactions conducted through the account that includes the following: "Each transaction identified in this account is subject to the election set forth in Sec. 988(a)(1)(B)."

In this example, it is assumed that the investor fulfilled his or her obligations for the election under Sec. 988(a)(1)(B), thereby resulting in the treatment of the gain as capital in character.

### Sec. 1256

Under Sec. 1256(a), certain contracts are generally required to be marked to market if held by the taxpayer at the close of the tax year and are further characterized as generating gain or loss that is 40% short-term capital gain or loss and 60% long-term capital gain or loss. Moreover, Sec. 1256(c) generally provides that Sec. 1256(a) applies even if the contract is not held at year end (e.g., because of a transfer, lapse, or other disposal during the year).

Sec. 1256(b), by its terms, covers the following types of contracts (which are defined under Sec. 1256(g)): (1) any regulated futures contract; (2) any foreign currency contract; (3) any nonequity option;

(4) any dealer equity option; and (5) any dealer securities futures contract. Having addressed regulated futures contracts and nonequity options above, and noting that the option is not a dealer equity option or a dealer securities futures contract (because *K* is not a dealer), that leaves open the question of whether the option is a foreign currency contract.

Under Sec. 1256(g)(2)(A), a foreign currency contract is defined as a contract that:

- Requires delivery of (or the settlement of which depends on the value of) a foreign currency that is a currency in which positions are also traded through regulated futures contracts;
- Is traded in the interbank market; and
- Is entered into at arm's length at a price determined by reference to the price in the interbank market.

In a nutshell, the option is not a foreign currency contract even though a casual reading might suggest otherwise. The rationale for this conclusion is as follows. In Notice 2007-71, the IRS states that foreign currency options, regardless of whether the underlying currency is one in which positions are traded through regulated futures contracts, are not foreign currency contracts as defined in Sec. 1256(g)(2). Apart from IRS resistance to what they view as an abuse (not relevant to our example), the notice explains that a

foreign currency contract . . . [is] a contract that requires delivery of, or the settlement of which depends on the value of, certain foreign currencies. The original statutory definition, however, did not allow for cash settlement and required actual delivery of the underlying foreign currency in all circumstances. Options, by their nature, only require delivery if the option is exercised. Section 102 of the Tax Reform Act of 1984 added the clause "or the settlement of which depends on the value of." There is no indication, however, that Congress intended by this addition to extend the definition of "foreign currency contract" to foreign currency options. That conclusion is confirmed by the legislative history to §988(c)(1)(E), enacted by the Technical and Miscellaneous

Revenue Act of 1988, which indicates that a foreign currency option is not a foreign currency contract as defined in §1256(g)(2). [Citations omitted.]

Moreover, Field Service Advice (FSA) 200025020 (issued prior to Notice 2003-81, which was modified and supplemented by Notice 2007-71) provided the following reasoning:

Although the definition of a foreign currency contract provided in § 1256(g)(2) may be read to include a foreign currency option contract, the legislative history of the Technical Corrections Act of 1982, which amended § 1256 to include foreign currency contracts, indicates that the Congress intended to extend § 1256 treatment only to foreign currency forward contracts that are traded on the interbank market. There is no indication that foreign currency option contracts were contemplated for inclusion in the statutory definition of a forward currency contract in § 1256(g)(2)(A).

Sections 1256(g)(3) and (4) deal comprehensively with options listed on a qualified board or exchange. These provisions were added to the Code by section 102(a)(3) of the Tax Reform Act of 1984. They provide that only dealer equity options (i.e., listed stock options) and listed options (other options listed on exchanges) are § 1256 contracts. The legislative history to these provisions is silent regarding whether the failure to separately include a provision addressing the treatment of foreign currency options was due to their having been included within § 1256(g)(2)(A). [Citations omitted.]

Further, commentators have seemed to accept (or at least not dispute) that foreign currency options are not foreign currency contracts. Consequently, the option should not be treated as a foreign currency contract and thus does not fall under Sec. 1256.

### **Holding Period**

Having established that the option is a capital asset and is not subject to Sec.

1256, the final step in the analysis is determining whether the gain on its disposition is long term or short term. Sec. 1222 generally controls the holding period of property in determining the long-term versus short-term character of the gain (or loss) on the disposition of a capital asset. In short, that section provides that capital gains are short term if held for not more than one year and long term otherwise.

Without going into a great deal on this issue (because it should be fairly apparent from the trade and termination dates being less than 12 months), it is clear that the gain is short term in nature.

### **Conclusion**

As can be seen from the above, reaching the ultimate answer to the initial query was not exactly a straightforward proposition, highlighting the need for additional clarity in similar situations. After all, even in this relatively simple example the conclusion was dependent on a close and critical reading of the legislative history, given several easily misinterpreted terms in the statute itself.

*From Andrew Gantman, CPA, Woodland Hills, CA*

### **U.S.-Source FDAP Income Compliance Designated as Tier 1 Issue**

The IRS has designated the obligation of U.S. withholding agents to report and withhold on U.S.-source fixed or determinable annual or periodic (FDAP) income as a Large and Mid-Size Business (LMSB) Division Tier 1 issue. Tier 1 issues are issues of high strategic importance to the LMSB and have a significant impact on one or more industries. The IRS is concerned that some taxpayers have used strategies to minimize withholding taxes, such as securities lending, payments to foreign vendors, and potential use of total return swaps. The IRS is also focusing on the quality of the overall reporting and withholding systems and procedures of the withholding agents to ensure proper classification of payments, sourcing, and validity of documentation of foreign persons.

### **Background**

Generally, foreign persons are subject to federal income tax on their U.S.-source income under the following rules:

1. Income that is effectively connected with a U.S. trade or business is taxed on a net basis at U.S. graduated tax rates; and
2. FDAP income is subject to gross taxation at a flat 30% tax rate if it is derived from U.S. sources and is not taxable as U.S. effectively connected income under rule (1). (Note that a tax treaty may reduce or eliminate the flat 30% tax rate.)

FDAP income is all income except for gains from the sale of property (including market discount and option premiums but not including original issue discount) and items of income excluded from gross income without regard to the owner's U.S. or foreign status, such as tax-exempt municipal bond interest and qualified scholarship income. Examples of FDAP income include compensation for personal services, dividends, interest, original issue discount, pensions and annuities, alimony, real property income (such as rents) other than gains from the sale of real property, royalties, taxable scholarship and fellowship grants, and commissions.

### **Withholdings on FDAP income**

Generally, a withholding agent must withhold 30% tax on FDAP income unless the agent can reliably associate the payment with documentation that the payment is made to (1) a payee that is a U.S. person or (2) a foreign beneficial owner who is eligible for a reduced rate of withholding. (The documentation process is sometimes referred to as "self-certification.") Withholding is not required, however, when a foreign person assumes withholding responsibility as a qualified intermediary.

A withholding agent is a person who is required to deduct and withhold taxes under the provisions of Secs. 1441, 1442, 1443, or 1461. A U.S. or foreign person that has control, receipt, custody, disposal, or payment of any item of income of a foreign person that is subject to withholding is a withholding agent. Several persons may be withholding agents for a single payment,

but the full tax is required to be withheld only once. Generally, the U.S. person who pays an amount subject to withholdings is the person responsible for the withholdings; however, other persons may be required to withhold. For instance, a payment made by a nonqualified intermediary that knows or has reason to know that the full amount was not withheld by the person from which it received payment is required to do the appropriate withholdings.

**Withholding agent liable for tax:** A withholding agent is personally liable for any tax that is required to be withheld. The withholding tax liability is independent of the tax liability of the foreign person to whom the payment is made. Accordingly, if a withholding agent fails to withhold a tax and the foreign person does not satisfy its U.S. tax liability, both the withholding agent and the foreign person are liable for tax, interest, and penalties on the outstanding balances due.

### Common Types of FDAP Income

**Interest:** With specific exceptions, such as portfolio interest, taxes must be withheld on interest from U.S. sources paid to foreign payees (interest income is sourced according to an individual obligor's residence and a corporate obligor's place of incorporation). Domestic corporations must withhold on interest credited to foreign subsidiaries or foreign parents. A treaty may permit a reduced rate or exemption for interest paid by a domestic corporation to a controlling foreign corporation. The interest may be on any type of debt, including open or unsecured accounts payable, notes, certificates, bonds, or other evidence of indebtedness.

**Dividends paid by U.S. corporations:** Generally, a U.S. corporation making a distribution with respect to its stock is required to withhold on the entire amount of the distribution. However, a distributing corporation may elect not to withhold on the part of the distribution that:

- Represents a nontaxable distribution payable in stock or stock rights;
- Represents a distribution in exchange for stock;
- Is not paid out of current or accumulated earnings and profits; or
- Represents a capital gain dividend.

**Royalties:** Royalty income is sourced where the property is used. Income from the sale of intangible property is treated as royalty income if the amount received is contingent on productivity, use, or disposition of the property. A 30% tax on U.S.-source income applies to the extent that the royalty income is not effectively connected with the conduct of a trade or business within the United States.

### Potential Impact of Fiscal Year 2010 Revenue Proposals

The Obama administration's fiscal year 2010 revenue proposals include recommended changes to withholdings on payments of FDAP income. According to the *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, "The Administration is concerned that some persons that are not entitled to an exemption from withholding tax or a reduced rate of withholding tax may attempt to avoid U.S. tax by arranging to receive payments through foreign intermediaries that are not qualified intermediaries (nonqualified intermediaries)" (Department of the Treasury (May 2009), p. 43, [www.ustreas.gov/offices/tax-policy/library/grnbk09.pdf](http://www.ustreas.gov/offices/tax-policy/library/grnbk09.pdf)).

The administration proposes making the following change: "Any withholding agent making a payment of FDAP income to a nonqualified intermediary would be required to treat the payment as made to an unknown foreign person (and therefore to withhold tax at a rate of 30 percent)" (id.). The rationale for this proposed change is that it "would discourage U.S. and foreign persons from attempting to avoid U.S. tax or to obtain a lower rate of withholding tax by providing incorrect self-certification or otherwise relying on the lack of information reporting associated with using nonqualified intermediaries" (id.). The proposal would be effective for payments made after December 31 of the year of enactment.

### Conclusion

Foreign persons are subject to U.S. tax on their U.S.-source FDAP income. If the FDAP income is not U.S. effectively connected income, the income is subject to withholding at a flat rate of 30% by the U.S. withholding agent, unless the flat

30% tax rate is reduced or eliminated under a tax treaty.

As evidenced by the IRS's designation of potential underreporting and withholding on U.S.-source FDAP income as a Tier 1 compliance issue, and the Obama administration's proposed changes to require a withholding agent making a payment of FDAP income to a nonqualified intermediary to treat the payment as made to an unknown foreign person (and therefore to withhold tax at a rate of 30%), it is clear that there will be increased scrutiny of FDAP reporting and withholding requirements in the future.

The withholding agent is personally liable for any tax required to be withheld. If the withholding agent fails to withhold and the foreign payee fails to satisfy its U.S. tax liability, both the withholding agent and the foreign payee are liable for tax, interest, and penalties. Accordingly, U.S. payers of FDAP income need to understand the reporting and withholding requirements related to FDAP income to minimize their audit risk and their personal tax liability for missed withholdings.

From Daniel Faulk, CPA, MBA, San Jose, CA

## GROSS INCOME

### Tax Treatment of Employment-Related Judgments and Settlements

Recent program manager technical assistance from the Office of Chief Counsel (PMTA-2009-035) provides a detailed analysis of the IRS's position on dealing with income and employment tax consequences, as well as appropriate reporting, of employment-related judgment or settlement payments. The PMTA goes on to state that determining the correct treatment of employment-related settlement payments is a four-step process:

- Determine the character of the payment and the nature of the claim that gave rise to the payment;
- Determine whether the payment constitutes an item of gross income;
- Determine whether the payment is wages for employment tax purposes; and

- Determine the appropriate reporting for the payment and any attorneys' fees (Form 1099 or Form W-2).

This item highlights the PMTA's key areas and points out important concepts.

### Character of the Payment and Nature of the Claim

There are numerous types of settlement payments or awards that an individual may receive in connection with an employment-related dispute. Some of these payment types include severance pay, back pay, front pay, compensatory damages, consequential damages, and punitive damages. In addition, depending on the specific set of facts and circumstances, the nature of the claim can be tied back into a federal provision or statute. Some of the most widely known of these include title VII of the Civil Rights Act of 1964, the Back Pay Act, the Age Discrimination in Employment Act of 1967, and the Fair Labor Standards Act of 1938.

### Taxable or Not

The first step in deciding whether a payment or settlement is taxable can be found in Sec. 104. Sec. 104(a)(2) states that "gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness." While this definition might seem clear and concise, there are several things to point out.

First, in order to comply with the regulations promulgated under Sec. 104, payments of damages must have been received either through prosecution of a legal suit or in a settlement agreement in lieu of prosecution of a suit. A general release of claims against an employer under a termination plan or severance package is not a claim under Sec. 104 and thus is taxable. Second, emotional distress cannot be treated as a physical injury or physical sickness, so payments in connection with an emotional distress injury do not qualify for a Sec. 104(a)(2) exclusion. Finally, the claim must be for a tort or tort-like injury to be excluded under Sec. 104(a)(2).

### Employment Tax Treatment (FICA and Income Tax Withholding)

Under Sec. 3101, FICA tax is owed on all payments made by an employer to its employees. Under Sec. 3402(a), an employer is required to withhold income tax on all wages paid to its employees. However, if amounts are not income and fall within Sec. 104(a)(2), they are not wages for FICA and income tax purposes.

Severance pay is a payment made by an employer to an employee upon the involuntary termination of employment and is taxable to the recipient. Severance pay, like the pay it replaces, is considered wages for FICA and income tax withholding purposes.

Back pay is compensation paid to an individual to compensate him or her for pay he or she would have received up to the time of settlement or court award and for the employer's wrongful conduct. It can be awarded to an employee if he or she is illegally terminated by an employer or to an applicant for employment who is not hired for illegal reasons. The IRS and the courts agree that back pay is wages for FICA and income tax withholding purposes, except if the back pay is received because of a personal physical injury or physical sickness.

The PMTA reiterates the IRS's rulings position that back pay awarded for an illegal refusal to hire is considered wages for federal employment tax purposes, but it also acknowledges *Newhouse v. McCormick & Co.*, 157 F.3d 582 (8th Cir. 1998). In this case, applicable in the seven states of the Eighth Circuit (Minnesota, North Dakota, South Dakota, Iowa, Nebraska, Missouri, and Arkansas), the court held that FICA tax and income tax withholdings do not apply unless there was an actual employer-employee relationship.

Front pay is paid to an individual to compensate for pay he or she would have received after the settlement date or court award and for the employer's wrongful conduct. The PMTA indicates that the IRS's position is that front pay is considered wages for FICA. It does, however, also note *Dotson*, 87 F.3d 682 (5th Cir. 1996). In this case, which applies only in the three states of the Fifth Circuit (Texas, Louisiana, and Mississippi), the court concluded that only the back pay portion of a settlement was wages for FICA tax purposes.

### Attorneys' Fees and Interest and the Allocation of Payments

Another important question to consider is whether payments received for attorneys' fees and interest should be included in gross income and considered wages for federal employment tax purposes. The IRS originally discussed this in Rev. Rul. 80-364 and reiterated it in the PMTA.

If the courts are able to break out the award into distinct components, the attorneys' fees and interest, while still includible in gross income, will not be subject to employment taxes. If not, then the full amount will be considered wages. The PMTA urges courts to break down the amount of the award into its respective elements, such as back pay, emotional distress damages, attorneys' fees, etc., which would make it much easier to determine which portion constitutes wages.

### Conclusion

It is important that tax preparers understand the rules regarding what is includible in gross income, what is considered wages and subject to FICA and income tax withholding, and the respective reporting requirements for each type of judgment or settlement. PMTA 2009-035 goes into great detail discussing the above rules and even provides a four-page chart summarizing the findings, so practitioners should be able to use it to provide assistance and reliable, sound advice to their clients in these areas.

From Shashi Mirpuri, CPA, MST, Woodland Hills, CA

## INDIVIDUALS

### Dependency Exemption for Divorced or Separated Parents

When a child is supported by his or her parents, the dependency exemption is normally a simple matter. However, the situation is much more complicated when it comes to divorced or separated parents.

### Law

A child is normally considered the dependent of the parent who has custody of the child. Sec. 152(e) states that a child, supported by his or her divorced or separated parents, will be the dependent of the non-custodial parent only if the custodial parent

signs a written declaration that the custodial parent will not claim the child as a dependent for a particular tax year (Sec. 152(e)(2)(A)). In addition, the noncustodial parent must attach the written declaration to his or her tax return (Sec. 152(e)(2)(B)). If the child spends exactly 50% of the time with each parent, the custodial parent is deemed to be the one with the higher adjusted gross income (Regs. Sec. 1.152-4(d)(4)).

Note that child support, alimony, or any other payment by either parent is never considered. The custodial parent can claim the dependent unless the right is released for a particular year or years.

### Attachment Required Before July 3, 2008

Prior to the enactment of Regs. Sec. 1.152-4(e), the IRS stated in Publication 501, *Exemptions, Standard Deduction, and Filing Information*, that a noncustodial parent could attach to his or her tax return certain pages of a divorce decree that conformed to the substance of Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*, to serve as the written declaration required by Sec. 152(e)(2)(B). However, the divorce decree had to state (1) that the exemption is available without regard to any condition, such as payment of support; (2) that the custodial parent will not claim the deduction; and (3) the years in which the noncustodial parent can claim the deduction.

### Regulations After July 2, 2008

Effective for tax years beginning after July 2, 2008, Regs. Sec. 1.152-4(e) specifies the details of the written declaration to be attached to the tax return, and a divorce decree no longer qualifies.

In the written declaration, the release must be unconditional. For instance, it cannot be dependent upon the payment of child support. The release must specify the year or years for which it is effective and must name the noncustodial parent (Regs. Sec. 1.152-4(e)(1)(i)). Form 8332 is used for this, but a substitute form may be used as long as it is only for the release of the dependency exemption (Regs. Sec. 1.152-4(e)(1)(ii)). Because the substitute form can be used only for the release of

the dependency exemption, the divorce decree cannot be used.

The general rule is subject, however, to the rule in Regs. Sec. 1.152-4(e)(5), which allows a noncustodial parent to continue to attach pages of a divorce decree executed on or before July 2, 2008, if the pages constitute a statement substantially similar to Form 8332 under the requirements in effect at the time the decree was executed.

### Swafford

It is very important for the noncustodial parent to follow the regulations. A recent case illustrates this point. In *Swafford*, T.C. Summ. 2009-82, the taxpayer was the noncustodial parent of his daughter. There was an agreement under a court order from a state court that as long as the taxpayer paid his child support, the exemption would go to the taxpayer in even years. In 2006, the taxpayer was current in his child support payments, so he claimed the daughter as a dependent.

Unfortunately, he did not have a signed Form 8332 or its equivalent. Therefore, the court held that the taxpayer had not satisfied the express requirements of Sec. 152(e), so he was not entitled to the exemption. The tax court noted that “[t]he mere fact that the State court granted the taxpayer the right to claim the dependency exemption deduction is immaterial because a State court cannot determine issues of Federal tax law.”

### Reason for Form 8332

Chief Counsel Advice (CCA) 200925041 spells out why Form 8332 or its equivalent would be required. According to the CCA, in amending Sec. 152(e) Congress wanted to avoid problems with substantiating whether conditions were met. For instance, in a situation such as that in *Swafford*, Congress did not want the IRS to have to determine whether the child support payments were made so that the noncustodial parent could claim the exemption.

### Conclusion

If a taxpayer is a noncustodial parent and wants to claim the child as a dependent, he or she must be sure to get the release signed and in writing, even if there is a court order to allow the noncustodial parent to

claim the child. Such an order violates Regs. Sec. 1.152-4(e) and does not have an effect on the operation of federal tax law.

From Ali Allison, CPA, MST, Los Angeles, CA

## LLCs & LLPs

### LLCs, LLPs, and the Passive Loss Rules

Since the early 1990s, limited liability company (LLC) and limited liability partnership (LLP) entities have been popular vehicles in which to structure a business. Their popularity is due to the fact that they can be used to limit personal liability and to avoid double taxation.

Sec. 469(h)(2) treats a limited partner's losses from an interest in a limited partnership as presumptively passive. The IRS has taken the position that a taxpayer who is a member of an LLC or LLP that is taxed as a partnership should be treated as a limited partner and therefore any losses passed through to the member are passive activity losses. This is to the taxpayer's disadvantage because it delays the deduction of losses and increases the amount of taxes currently paid by business owners.

In *Thompson*, No. 06-211 T (Fed. Cl. 7/20/09), the Court of Federal Claims held that an ownership interest in an LLC should not be treated as presumptively passive under Sec. 469 for two main reasons. First, the court found that Temp. Regs. Sec. 1.469-5T(e) applied only to an entity organized as a limited partnership under state law. Second, the court held that the rationale for treating limited partnership interests as presumptively passive did not apply to LLC interests because an LLC member, unlike a limited partner, is not statutorily prohibited from participating in the entity's affairs. Therefore, it is possible that an LLC member could materially participate in an LLC's business, making the passive activity presumption improper.

### Background of the Case

In the *Thompson* case, the taxpayer owned an airline charter that operated as an LLC under Texas state law. The business, Mountain Air Charter, LLC, was owned 99% by the taxpayer directly; the remaining 1% was owned by JRT Holdings, Inc., an S

corporation, which was also owned by the taxpayer. During 2002 and 2003, the company incurred substantial losses, which the taxpayer used to offset ordinary income on his personal tax return. On audit, the IRS took the position that the LLC was a limited partnership for purposes of Sec. 469(h)(2), which was accordingly subject to the passive activity rules of Sec. 469. Therefore, the losses had incorrectly been deducted.

### The IRS's Position

The IRS based its position on Temp. Regs. Sec. 1.469-5T(e)(3)(i):

(3) Limited partnership interest

(i) In general.—Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if—

(A) Such interest is designated a “limited partnership interest” in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder’s capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).

According to the IRS, because the LLC had limited liability, the LLC interest was a “partnership interest [that] shall be treated as a limited partnership interest” for purposes of Sec. 469(h)(2), and therefore the interest should be treated as an interest in a passive activity.

### The Court's Holding

The Court of Federal Claims found that Sec. 469(h)(2) and the regulations made it clear that a limited partnership interest must

be an interest in an entity established under state law as a limited partnership and not merely an entity that elects to be taxed as a partnership. As set forth in Temp. Regs. Sec. 1.469-5T(e)(3)(i)(A), “Such interest [must be] designated a ‘limited partnership interest’ in the limited partnership agreement or the certificate of limited partnership” in order to be considered a limited partnership. Because Mountain Air Charter was a valid Texas LLC, not a limited partnership, the court held that an interest in Mountain Air should not be treated as a limited partnership interest for purposes of Sec. 469.

The court also addressed the application of the general partnership exception in Temp. Regs. Sec. 1.469-5T(e)(3)(ii), which states:

(ii) Limited partner holding general partner interest.—A partnership interest of an individual shall not be treated as a limited partnership interest for the individual’s taxable year if the individual is a general partner in the partnership at all times during the partnership’s taxable year ending with or within the individual’s taxable year (or portion of the partnership’s taxable year during which the individual (directly or indirectly) owns such limited partnership interest).

The court found that whether the exception applied depended on the potential for participation in the entity. According to the court, the rationale for treating a limited partnership interest as presumptively passive did not extend to LLC interests because there were no statutory limitations on the partners’ or members’ participation in an LLC under state law, and it therefore could not be presumed that an LLC member did not materially participate.

This led the court to conclude that it was inappropriate to presume that the interests in an LLC were passive. Therefore, the court held that Thompson’s interest should be treated as a general partnership interest that was covered by the exception in Temp. Regs. Sec. 1.469-5T(e)(3)(ii). In Thompson’s case, because the parties had stipulated that Thompson would meet the material participation requirements of Sec. 469 with respect to Mountain Air

Charter if Temp. Regs. Sec. 1.469-5T(e)(3) did not apply, the court held that Thompson’s losses from the LLC were not limited.

In making its holding on the general partnership exception, the court cited with approval the Tax Court’s decision in *Garnett*, 132 T.C. No. 19 (2009), which was issued shortly before the decision in the *Thompson* case. In *Garnett*, the Tax Court addressed the same issue as in *Thompson* with respect to both LLC and LLP interests. While the Tax Court agreed with the Court of Federal Claims on the application of the general partnership exception, it did not agree that an LLC interest should not be treated as a limited partnership interest because an LLC is not a limited partnership under state law. The Tax Court concluded that Congress had contemplated that entities that are substantially equivalent to limited partnerships are considered presumptively passive under Sec. 469(h)(2), so an LLC interest was not excepted from Sec. 469(h)(2) simply because it was not a limited partnership under state law.

### Conclusion

These holdings favor LLC members’ ability to take losses currently. In 2009, practitioners probably have many clients with LLCs that have incurred substantial losses either in the current year or in prior years. One way to assist these clients is to reevaluate the position taken on prior-year tax returns to see if losses have been suspended. If losses are substantial, it may be worth the time and cost to amend those returns. However, since there is a higher risk of audit when returns are amended, a practitioner’s best practice would be to sit down with the client and document, in either a written memo or a flow chart, the flowthrough of income and losses and the client’s participation in those companies.

From Cecilia Calderilla, CPA, Irvine, CA

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### EditorNotes

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