

Tax News for Business Lawyers

Spring 2009

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- How the Attorney Work Product Doctrine Can Protect Tax Accrual Workpapers from IRS Summons

■ Executive Committee Members

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Note from the Committee Chair



April 3, 2009

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Atlanta, Georgia

Our revised list of programs for the [Spring 2009 Meeting](#) in Vancouver is [below](#). We are the primary sponsor of one program, and cosponsor of two others.

Our own program, 2:30 PM - 4:30 PM on Friday April 17 will focus on U.S.-Canada cross-border mergers and acquisitions, with a stellar panel of both U.S. and Canadian lawyers. We will have a brief informal committee meeting after the program.

Registration is open for the annual "Taxation of Business Transactions," to be held May 18, 2009 - May 19, 2009, at the InterContinental Hotel in Atlanta. As in the past, the program is co-sponsored by the ABA Section of Business Law, and Committee members are taking an active part. All ABA members are entitled to the discounted registration fee of \$349 for the two day seminar. Go to: <http://www.sbtffi.org/>.

Planning has begun for our programs at the 2009 Annual Meeting in Chicago. We are working with the ABA Section of Taxation on a program dealing with "Buy-Sell Agreements for Closely Held Businesses and Professional Practices," but have not yet decided on our own program.

On March 12, 2009, we cosponsored a teleconference with the ABA Tax Section on preserving privilege for client communications. This teleconference was based on a similar program that we cosponsored at the ABA Annual Meeting in New York last year. You can purchase the materials and a recording of the teleconference by [clicking here](#).

We are making progress on our long-delayed book. Apologies to those of you who drafted pieces and are anxious to see the finished product. You will hear from me soon.

Karl Ege, Chair of the Section, called my attention to recent scams in which fraudulent emails, purporting to come from the IRS, "phish" for personal information. One of the scams features the completely fictional "Form W-4100B2," which purports to call for, among other things, the recipient's social security number and bank account information. As the IRS web site warns, the IRS does not initiate taxpayer communications through email, and does not request detailed personal or financial information through email. For further information, see <http://www.irs.gov/privacy/article/0,,id=179820,00.html>

Friday, April 17:

8:00 AM - 10:00 AM

Employee Benefits and Executive Compensation Program:

Hot Topics in Cross-Border Executive

Cosponsored by: Committee on Taxation

Chair: Martha Steinman

2:30 PM - 4:30 PM

Tax Committee Program:

US - Canada Cross Border Mergers and Acquisitions - Tax Considerations in a Distressed Global Economy

Cosponsored by Committee on International Business Law and Committee on Mergers and Acquisitions)

Chair: Scott Harty

Saturday, April 18:

8:00 AM - 10:00 AM

Private Equity and Venture Capital Committee Program:

Exploring the Reasons behind the Bias of Private Equity and Venture Capital Firms Investing in Corporations Rather than Limited Liability Companies - Time to Reconsider

Cosponsored by Committee on LLCs, Partnerships and Unincorporated Entities and Committee on Taxation

Chair: Paul 'Chip' L. Lion III

Registration information for the ABA Annual Meeting is available on the [ABA's website](#).

Featured Articles

[The Business Tax Changes of the Recovery Act: Loan Workouts, Tax Incentives for Small Businesses, and Ownership Changes of Banks](#)

Saba Ashraf, Troutman Sanders LLP

The American Recovery and Reinvestment Act of 2009 (the "Recovery Act") was signed into law by President Obama on February 17, 2009. The Recovery Act contains several helpful business tax changes, including: (i) provisions making it easier for taxpayers to "workout" or restructure outstanding debt, (ii) provisions providing various incentives for small businesses and their owners, and (iii) a provision prospectively repealing the Treasury notice issued last year preserving tax losses of banks.

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[Purchasers of Stock Must Be Aware of New IRS Regulations](#)

Steven C. Gove and Thomas N. Lawson, Loeb & Loeb LLP

If you plan to acquire a business by purchasing the stock of a corporation, you need to be aware of two sets of new guidance recently issued by the IRS, both of which may affect the tax attributes of the target after the acquisition.

Seller's Tax Loss on Disposing of Target May Now Impair Target's Tax Attributes

The first set consists of final consolidated return regulations applicable to transactions after September 17, 2008 and is relevant only if you purchase the stock of a subsidiary that is

included in a consolidated federal income tax return with the selling parent company. The regulations apply when the parties *do not* elect under Internal Revenue Code (hereafter "IRC" or "Code") Section 338(h)(10) to treat the transaction as an asset sale.

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IRS Gives Guidance on Deferred Compensation from Offshore Funds

Timothy P. Burns, Mark C. Jones and Kathleen Bardunias, Pillsbury Winthrop Shaw Pittman LLP

On January 8, the Internal Revenue Service (IRS) issued preliminary guidance on the taxation of deferred compensation from offshore investment partnerships and other tax-indifferent entities. Notice 2009-8, which is intended to provide interim guidance under Internal Revenue Code Section 457A until formal regulations are adopted, answers critical questions raised after the initial enactment of Section 457A and affirms that Section 457A is intended to have a wider scope in many respects than the counterpart provision on deferred compensation, Section 409A.

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IRS Extends Favorable Stock Dividends Guidance to RICs

Joy S. MacIntyre, Karen Guo and Shane M. Shelley, Morrison & Foerster LLP

In December 2008, the Internal Revenue Service (the "IRS") issued Revenue Procedure 2008-68, providing temporary guidance regarding certain stock distributions by publicly traded real estate investment trusts ("REITs"). The taxpayer-favorable guidance gave publicly traded REITs greater flexibility to satisfy their tax-related distribution requirements while conserving cash in an illiquid market. On January 7, 2009, the IRS issued Revenue Procedure 2009-15 (the "Procedure"), extending its prior guidance to publicly traded regulated investment companies ("RICs"). Effective January 1, 2008 and for taxable years ending on or before December 31, 2009, the IRS will treat a distribution of stock by a publicly traded REIT or RIC pursuant to certain elections to receive stock or cash as a taxable distribution of property. The Procedure only applies to a REIT or RIC publicly traded on an established U.S. securities market. The amount of the stock distribution will be treated as equal to the amount of cash that could have been received instead. Under the Procedure, REITs and RICs can limit the aggregate amount of cash available to shareholders pursuant to the election to 10 percent of the aggregate distribution of cash and stock taken together. Given the requirement that a REIT or RIC be publicly traded on an established securities market, the Procedure generally will not apply to open-end mutual funds, and will only apply to ETFs and closed-end funds that are traded on a U.S. exchange rather than in the over-the-counter market.

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[Temporary Regulations Close Repatriation Loophole in Stock Transfers to Foreign Corporations](#)

Edward Tanenbaum and Tola Ozim, Alston & Bird, LLP

On February 10, 2009, the Internal Revenue Service (IRS) issued temporary regulations ("Temporary Regulations") on the application of Section 367 of the Internal Revenue Code ("Code") in cross-border stock transfers governed by Code Section 304. The Temporary Regulations are intended to stop a transaction used by some taxpayers to repatriate cash to the United States tax-free and address an aspect of that transaction, which takes place under Code Section 304, previously addressed in 2006 final regulations. The Temporary Regulations apply to transfers or distributions on or after Feb. 11, 2009.

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[Although Changes in Law are Possible, Changes to Fund Compensation Structures are Premature](#)

David A. Goldstein and Jeremy M. Naylor, White & Case LLP

Since the first publication of this article, President Obama has announced in his budget proposal for Fiscal Year 2010 his support for carried interest being taxed at ordinary income rates, beginning in 2011; however, the authors of this article believe that the message expressed here still stands.

Recent press articles suggest that private investment fund sponsors should restructure the way "carried interest" is paid in their funds in order to avoid or lessen the impact of potential changes in tax law previously announced by President Barack Obama. In our view, any such changes are premature and could lock fund sponsors into adverse economic arrangements or have adverse tax effects if implemented before any such legislation is passed.

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[How the Attorney Work Product Doctrine Can Protect Tax Accrual Workpapers from IRS Summons](#)

Robert T. Duffy, Kilpatrick Stockton LLP

*Editor's Note: As we were going to press (March 25), the First Circuit vacated its decision in *Textron* and scheduled an en banc hearing for June 2. Nevertheless, the practical advice set forth in this article remains valid and important.*

In this IRS summons case, the Court of Appeals for the First Circuit, one judge dissenting, ruled that Textron's tax accrual workpapers are attorney work product and are protected against forced disclosure to the IRS.

The appeals court, however, remanded the case to the district

court to consider whether Textron must produce the tax accrual workpapers that Ernst & Young ("E & Y") prepared and still holds. The remand potentially threatens the protection against disclosure of the very Textron tax accrual workpapers that the First Circuit's opinion protects for now.

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The Business Tax Changes of the Recovery Act: Loan Workouts, Tax Incentives for Small Businesses, and Ownership Changes of Banks

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The American Recovery and Reinvestment Act of 2009 (the “Recovery Act”) was signed into law by President Obama on February 17, 2009. The Recovery Act contains several helpful business tax changes, including: (i) provisions making it easier for taxpayers to “workout” or restructure outstanding debt, (ii) provisions providing various incentives for small businesses and their owners, and (iii) a provision prospectively repealing the Treasury notice issued last year preserving tax losses of banks.

I. Restructuring of Debt Made Easier

A. Deferral of Taxable Income From Certain Debt Workouts

The Recovery Act contains a provision pursuant to which businesses with taxable income resulting from restructured debt will be able to defer taxable income for up to 5 years, and then pay taxes on that taxable income over another 5 year increment.

By way of background, the proceeds of borrowing are not taxable income, as the borrower has an obligation to pay back such debt, so that the taxpayer has not “ascended to wealth.” However, when debt is cancelled, or retired at a discount, so that the taxpayer no longer has an obligation to pay back the face amount, there is resulting taxable income. Generally, if a taxpayer acquires or retires its debt at a discount to the face amount (whether through an exchange of cash or new debt for old debt, or indirectly by a modification of the old debt’s terms), the taxpayer has taxable income equal to the discount.

Under the Recovery Act, some relief is provided to taxpayers relating to taxable income resulting from the acquisition of debt or a modification of debt. A taxpayer may elect to defer cancellation of debt (“COD”) income arising from an acquisition by the taxpayer or certain related persons during calendar years 2009 and 2010, of a debt instrument issued by either a C corporation or any other person in connection with the conduct of a trade or business. The income is deferred for roughly a 5 year period. The income deferred must be included in the gross income of the taxpayer ratably in the 5 taxable years beginning with the 5th taxable year following the year of repurchase (and for repurchases in 2010, the 4th taxable year following the year of repurchase).

The Recovery Act further addresses the mismatch between certain interest deductions and COD income that would have occurred under current law unless addressed. Debt issued

that has a stated redemption price at maturity (generally, face amount) in excess of its “issue price” has “original issue discount”, or “OID”.¹ Debt issued in exchange for outstanding debt can often have an issue price less than its stated redemption price at maturity, and thus have OID. This deduction for OID may fall to a great extent in the years in which the COD income was deferred. Under the Recovery Act, however, if a taxpayer makes the election to defer COD income in connection with a debt-for-debt exchange in which the newly issued debt instrument has OID, then any deduction for interest in connection with the OID that accrues in the deferral period up to the amount of the COD, is deferred and allowed as a deduction ratably over the 5 year period in which the COD income is recognized.

Solvent as well as insolvent taxpayers may defer the taxable income pursuant to this provision. Further if COD income is deferred pursuant to this election, there is no associated requirement for a taxpayer to reduce its tax attributes such as NOLs (as would be required if a taxpayer excluded COD income based on an exclusion such as that based on the taxpayer’s insolvency). Electing debtors are ineligible for other Section 108 exclusions from income.

B. Limitations on Deductibility of Interest on High-yield Debt Instruments Eased Where Instrument Issued in Connection with Workout of Existing Loan

The Recovery Act encourages debt-for-debt exchanges in which the old debt is exchanged for new debt with a high-yield, by suspending some current limitations on the deductibility of interest on the new high-yield debt. Absent this provision, many taxpayers would have COD income resulting from a debt restructuring, and yet not be able to offset that COD income by interest deductions associated with the new or modified debt.

Ordinarily, the issuer of a debt instrument with OID may deduct the portion of such OID equal to the aggregate daily portions for the OID for the days in the taxable year. However, this is not so in the case of a debt instrument that is an applicable high yield debt obligation (“AHYDO”). A debt instrument is an AHYDO if it is long term (maturity date of greater than 5 years), and there is OID on the debt, and the yield to maturity is very high. If a debt instrument is an AHYDO, then the deduction for interest with respect to it is deferred, or wholly denied.

The Recovery Act suspends the limitations on such deductibility for certain obligations issued in a debt-for-debt exchange, including a deemed exchange resulting from a modification, after August 31, 2008 and during calendar year 2009. The suspension applies to debt instruments issued in exchange for a debt instrument (including any debt instrument deemed issued as a result of a significant modification of a debt instrument). However, the suspension does not apply to any newly issued debt instrument (including any debt instrument issued as a

¹ The issue price of debt exchanged for other debt is the trading price if either the new debt or the old debt is publicly traded. If neither is publicly traded, the issue price will generally be the stated principal amount of the new debt so long as it bears “adequate stated interest” (the applicable federal rate, published monthly by the IRS). If neither debt is publicly traded and there is no adequately stated interest, then the issue price is the imputed principal amount of the debt (the amount derived by discounting all payments of principal and interest using the applicable federal rate).

result of a significant modification of a debt instrument) that is issued for an AHYDO. The IRS is given the authority to apply the suspension rule to periods after 2009 where it determines that such application is appropriate in light of distressed conditions in the debt capital markets.

II. Tax Incentives Related to Small Businesses

A. Small Businesses May Carryback NOLs For Up To 5 years

Businesses with annual gross receipts of \$15 million may carryback NOLs for up to 5 years to obtain refunds of taxes.

A net operating loss (“NOL”) generally means the amount by which a taxpayer’s business deductions exceed its gross income. NOLs are valuable tax attributes as they reduce the amount of tax otherwise payable. Many taxpayers have no current taxable income against which they can use the NOLs, and furthermore do not expect to have taxable income in near future years against which they can use the NOLs. A lot of these taxpayers have, however, had taxable income in the previous few years, so that if they were permitted to carryback NOLs to those years, they would get a taxable refund. (Under current law, NOLs may be carried back 2 years, and forward 20 years to offset taxable income in such years.)

The Recovery Act provides a measure of relief for small businesses. Eligible small businesses (those generally with average annual gross receipts of \$15 million or less) have an election to increase the carryback period for NOLs for the taxable year ending in 2008 (or at the taxpayer’s election for any taxable year beginning in 2008) from the current 2 years to any whole number of years from 2 to 5. The election may be made only with respect to one taxable year.

Both the House and Senate bills had provisions that would have allowed for a 5 year carryback of NOLs without imposing a limit on the size of revenues of the business. Many business groups were reportedly unpleasantly surprised by the limited amount of relief in the Recovery Act, saying that an expanded provision would have been one of the most proven ways of helping struggling companies, creating jobs, and stimulating the economy.

B. Significantly Reduced Tax Rate on Gain From Sale of Small Businesses

Gain from the sale of qualified small business stock is subject to an effective regular tax rate of 7%.

Under current law, individuals may exclude 50% of the gain from the sale of certain small business stock acquired at original issue and held for at least 5 years. The portion of the gain includible in taxable income is taxed at a maximum rate of 28%. Thus, the gain from the sale of qualified small business stock is taxed at effective rates of 14% under the regular tax. The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) 10 times the taxpayer’s basis in the stock or (2) \$10 million. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not

exceed \$50 million. The corporation must also meet certain active trade or business requirements.

The percentage exclusion for qualified small business stock sold by an individual is increased from 50% to 75% by the Recovery Act. As a result, gain from the sale of qualified small business stock is taxed at the effective rate of 7% under the regular tax. The provision is effective for stock issued after the date of enactment and by the end of calendar year 2010.

C. Recently Converted S Corporations Have Shorter Holding Period for Avoiding Corporate Tax on Sale of Assets

C corporations that converted to S status over 6 years ago can avoid corporate tax on actual or deemed sale of assets, despite the fact that 10 years have not passed since conversion.

Under current law, if a taxable “C corporation” converts to an “S corporation” (which generally does not pay an income tax), the conversion is not a taxable event. However, following such a conversion, an S corporation must hold its assets for 10 years in order to avoid a tax on any built-in gains that existed at the time of the conversion. The Recovery Act reduces this holding period from 10 years to 7 years for sales occurring in 2009 and 2010.

D. Increase In Limitations on Expensing of Certain Depreciable Business Assets

Last year, Congress temporarily increased the amount of costs for certain depreciable business assets small businesses could “write-off” or immediately expense rather than depreciate over time to \$250,000 and increased the phase-out threshold for 2008 to \$800,000. Without the Recovery Act, the amount that could have been expensed in 2009 would be \$133,000. The Recovery Act allows certain small business taxpayers to elect to immediately expense \$250,000 with the investment ceiling of \$800,000 again. These amounts are not indexed for inflation. The increase in limits is applicable for 2009, after which time the limits will fall back to \$125,000 and \$500,000 (adjusted for inflation) for 2010, and then to \$25,000 and \$200,000 for 2011 and afterwards.

Small businesses, as well as many medium sized businesses will benefit from this provision, which makes the effective cost of business machinery and equipment significantly lower than it otherwise would be.

E. One-Year Extension for 50% First Year Depreciation Deduction

Although this provision is discussed under the section relating to small businesses, many medium and large businesses will benefit from this provision as well, as again, it would significantly reduce the effective cost for them of acquiring depreciable property.

Last year, Congress temporarily allowed businesses to deduct the costs of capital expenditures made in 2008 faster than the otherwise applicable depreciation schedule would allow by permitting these businesses to immediately deduct 50% of the cost of depreciable

property acquired in 2008 for use in the United States. The Recovery Act extends this temporary benefit for costs incurred in 2009.

F. Temporary Small Business Estimated Tax Payment Relief

The Recovery Act reduces the 2009 required estimated tax payments for small business owners.

III. Notice Preserving Tax Losses of Banks; General Motors

A. Prospective Repeal of Treasury Bank Loss Notice

The Recovery Act repeals Notice 2008-83, with Congress finding Treasury's legal authority to issue the notice "doubtful."

This is the Notice issued by Treasury in September 2008, prior to the enactment of the Emergency Economic Stabilization Act on October 3, 2008 ("Bailout Bill"). By way of background, if a corporation with NOLs undergoes a sufficient enough ownership change, then its NOLs become subject to a limitation. If this corporation had losses in its assets that had not yet been triggered for tax purposes (so called net unrealized built-in losses ("NUBILs"), then such NUBILs would also be subject to a limit. (Distressed banks likely would have NUBILs with respect to loans, particularly ones they've written down for book purposes, but not for the tax purposes.) This notice said that any deduction allowed after an ownership change to a bank with respect to losses on loans or bad debts would not be treated as a built-in loss or deduction that is attributable to periods before the change. Thus, the notice allowed banks to save significant amounts of NOLs from limitations that would otherwise have been imposed on their use. This notice received a lot of attention in the press, as it reportedly enabled Wells Fargo to make a superior bid for the purchase of Wachovia of approximately \$15 billion. As a result of the notice, a reported \$74 million of Wachovia losses could be triggered post-purchase and used to shelter taxable income without limits, with some estimating that the value of these NOLs to Wells Fargo could be greater than the purchase price of \$15 billion.

While the notice was repealed, it is allowed to have the force and effect of law with respect to (I) any ownership change occurring on or before January 16, 2009, and (II) those occurring after January 16, 2009 but pursuant to a written binding contract entered into on or before January 16, 2009 (or agreements that were described on or before January 16, 2009 in a public announcement or in a filing with the SEC required by reason of such ownership change).

B. Relaxation of Limits on Use of NOLs for Certain Corporations Receiving Funds from Treasury under Bailout Bill

At the same time, the Recovery Act provides an exception from the limitations on NOLs triggered by an ownership change of certain corporations.

Pursuant to the Recovery Act, the loss limitation that would otherwise arise as a result of an ownership change will not apply in the case of an ownership change that occurs pursuant to a restructuring plan of a taxpayer which is required under a loan agreement or commitment for a line of credit entered into with the Department of the Treasury under the Bailout Bill, and is intended to result in a rationalization of the costs, capitalization, and capacity with respect to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries. An ownership change that would otherwise be excepted from the Section 382 limitation under the provision will instead remain subject to the Section 382 limitation if, immediately after such ownership change, any person owns stock of the new loss corporation possessing 50% or more of the total combined voting power of all classes of stock entitled to vote or of the total value of the stock of such corporation.

It is speculated that this provision likely would apply only to General Motors.

Purchasers of Stock Must Be Aware of New IRS Regulations

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If you plan to acquire a business by purchasing the stock of a corporation, you need to be aware of two sets of new guidance recently issued by the IRS, both of which may affect the tax attributes of the target after the acquisition.

Seller's Tax Loss on Disposing of Target May Now Impair Target's Tax Attributes

The first set consists of final consolidated return regulations applicable to transactions after September 17, 2008 and is relevant only if you purchase the stock of a subsidiary that is included in a consolidated federal income tax return with the selling parent company. The regulations apply when the parties *do not* elect under Internal Revenue Code (hereafter "IRC" or "Code") Section 338(h)(10) to treat the transaction as an asset sale.

If the seller realizes a loss on the sale of the subsidiary stock, then the subsidiary, now owned by the buyer, must reduce valuable tax attributes. Capital and net operating loss ("NOL") carryovers are eliminated first, up to the extent of the loss on sale realized by the seller. If the loss exceeds the amount of such carryovers, then the income tax basis of the subsidiary's assets is reduced. This will reduce your depreciation or amortization deductions and increase your tax gain if you sell any of the assets.

A seller may make two different elections to cause a different result. It can elect not to deduct its loss, in which case the subsidiary keeps its losses and basis; or, the seller can elect to re-attribute the subsidiary's NOL back up to the seller, which reduces the seller's basis in its stock and reduces or eliminates the loss on sale. Any amount of NOL that is re-attributed to the seller is not available to the subsidiary to offset income it earns during your period of ownership. To avoid unpleasant surprises, it is important for the buyer to negotiate with the seller over the treatment of the seller's prospective loss, or at least protect itself through representations and warranties in the agreement.

Proposed Regulations Would Allow More Stock Purchasers to Step Up the Basis of Target Assets

More transactions may be affected by the second set of regulations which is proposed regulations issued on August 25, 2008 under IRC Section 336(e). These regulations would expand the circumstances in which a stock purchase can be treated as an asset purchase for federal income tax purposes, thereby allowing the purchaser to obtain a cost basis in the assets of the target without directly acquiring those assets. The regulations will be effective when published as final regulations.

Generally, when a purchaser acquires the stock of a corporation ("Target"), the purchaser takes a "carried over" basis in Target's assets equal to Target's tax basis in those assets. By

contrast, when a purchaser acquires Target's assets, the purchaser takes a cost basis, generally equal to the value of the acquired assets. A cost basis is generally preferable to a carried over basis if the Target's assets are appreciated, since a cost basis will result in larger depreciation and/or amortization deductions.

The tax law has for many years provided two elections (under Code Sections 338(g) and 338(h)(10)) that allow a purchaser of at least 80 percent of the stock of Target over a 12-month period to treat the stock purchase as an asset purchase for federal tax purposes, and thereby obtain a cost basis in the assets without formally acquiring the assets. Both of these elections, however, are generally available only where the purchaser is a C corporation.

Unlike the other Section 338 elections, these new regulations under Section 336(e) do not require the purchaser to be a corporation (although both Seller and Target must be domestic C corporations). Another important difference between the Section 336(e) election and either the Section 338(g) election or the Section 338(h)(10) election is that the Seller makes the Section 336(e) election unilaterally. Such a unilateral election by Seller could have a negative impact on a purchaser that desires to use Target's prior NOLs to offset future income or to use the built in loss in certain assets to offset other gains. If the acquisition is treated as a stock sale, these NOLs (and any such built-in losses) would generally remain available to Target post-closing (subject to certain limitations). Where the Seller makes a Section 336(e) election to treat the transaction as an asset sale, however, Target would have its prior tax attributes (including the NOLs and such built-in losses) wiped out.

A prospective purchaser should take into account Seller's ability to unilaterally elect to eliminate Target's tax attributes by means of a Section 336(e) election when negotiating the purchase transaction with Seller. While the regulations are not effective until they are finalized, nobody knows when that will be. If you are negotiating now to purchase the stock of a corporation from a seller that is a C corporation, the possibility that this election will become available before your transaction closes should be taken into account. Overall, when finalized, the Proposed Regulations will provide greater flexibility to parties to transactions involving the sale of corporate subsidiaries.

IRS Gives Guidance on Deferred Compensation from Offshore Funds

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On January 8, the Internal Revenue Service (IRS) issued preliminary guidance on the taxation of deferred compensation from offshore investment partnerships and other tax-indifferent entities. Notice 2009-8, which is intended to provide interim guidance under Internal Revenue Code Section 457A until formal regulations are adopted, answers critical questions raised after the initial enactment of Section 457A and affirms that Section 457A is intended to have a wider scope in many respects than the counterpart provision on deferred compensation, Section 409A.

Background

The legislation codified as Section 457A of the Internal Revenue Code was attached to the Emergency Economic Stabilization Act of 2008 (EESA) as a revenue-raising device intended to partially offset the cost of the economic relief programs being enacted. Section 457A derived from draft legislation that had intended to render currently taxable, as ordinary income, performance fees and other forms of compensation benefiting U.S. managers of investment funds located in countries with favorable tax regimes. Generally, deferred compensation allocated pursuant to a nonqualified plan is governed by Code Section 409A. Under Section 409A, deferred compensation is not taxed until it is actually or constructively received by the service provider, as long as the service provider has made a timely deferral election and certain requirements under the Code are met.

Section 457A provides rules similar to those set forth in Section 409A to regulate the taxation of deferred compensation provided to U.S. taxpayers by certain partnerships and corporations that would otherwise be considered to be "tax indifferent" entities for the purposes of determining when they recognize income. One key difference with Section 457A is that the IRS will not honor a deferral election with respect to Section 457A income, unlike income that is subject only to Section 409A.

General Rules

Section 457A provides that deferred compensation under a nonqualified plan of a nonqualified entity will be includible in the taxpayer's gross income at the time that the compensation is no longer subject to a substantial risk of forfeiture. Section 457A generally applies to the same plans and taxpayers as Section 409A, except that Section 457A specifically applies to stock appreciation rights and certain other equity units excluded from the scope of

Section 409A. Notice 2009-8 adds a number of additional differences. Most significantly, Notice 2009-8 clarifies that accrual-basis taxpayers are included in Section 457A and carves out from its scope stock appreciation rights that must be settled in stock of the service recipient. Notice 2009-8 also provides that the receipt of a profits interest in a partnership will be treated substantially the same as under the existing guidance under Section 409A (which does not generally treat as a deferral of income the receipt of a profits interest not otherwise required to be included in income). Accordingly, investment funds structured to use profits interests (e.g., carried interest allocations) in lieu of performance fees should generally not have a different result with respect to such items under Section 457A than under existing Section 409A.

Section 457A defines a “nonqualified entity” as:

- 1) any foreign corporation unless substantially all of its income is
 - (A) effectively connected with the conduct of a trade or business in the United States, or
 - (B) subject to a comprehensive foreign income tax, and
- 2) any partnership unless substantially all of its income is allocated to persons other than –
 - (A) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and
 - (B) organizations which are exempt from tax under this title.

Notice 2009-8 provides that the first prong of this test is met if 80 percent or more of the corporation’s gross income is effectively connected with the conduct of a U.S. trade or business. For all other foreign corporations, Notice 2009-8 sets out a three-part test:

- 1) The corporation must be subject to a comprehensive tax treaty with the United States (excluding the treaties with Bermuda and the Netherlands Antilles);
- 2) The corporation must not be taxed by its country of residence under a regime that is materially more favorable than the corporate income tax generally paid by that country. (This provision is intended to exclude certain countries, such as Ireland, that afford preferential tax treatment to distributed interest income); and
- 3) The corporation must not reside in a country, such as Germany, with a territorial tax regime – that is, a system of taxation that excludes nonresident source income, if such income comprises 20 percent or more of the corporation’s total gross income.

Similar rules apply to partnership, and Notice 2009-8 sets forth specific rules on the allocation of income among partners for this purpose, including rules for determining allocations in the context of tiered ownership structures. In general, the tiered ownership rules focus on

whether a particular item of income is taken into account under the laws of the jurisdiction of the foreign indirect owner other than under an anti-deferral regime (such as the controlled foreign corporation or passive foreign investment company rules or analogous non-U.S. provisions). As a practical matter, it may be difficult to determine whether a partnership is a nonqualified entity where entities in multiple foreign countries hold the partnership interests or where a tiered ownership structure is involved.

A corporation is determined to be a nonqualified entity by applying the above analysis as of the last day of the service provider's taxable year. The analysis of a partnership is based on the allocations for the partnership's tax year ending with or within the service provider's taxable year. Therefore, Section 457A applies to all compensation that vests over the year (or in a prior year, to the extent not previously taken into income) if the service recipient becomes a nonqualified entity at any time during the year and is deemed to be a nonqualified entity on the last day of the plan sponsor's taxable year.

Under Section 457A, compensation is subject to a substantial risk of forfeiture only if the taxpayer's right to the compensation is conditioned on his or her future service. Notice 2009-8 clarifies that stock rights and other rights to compensation that are conditioned on a particular growth benchmark will not be considered as subject to a substantial risk of forfeiture.

Section 457A sets out one exception to this definition of substantial risk of forfeiture. If the amount of deferred compensation is indeterminable when it vests, then Section 457A allows the taxpayer to defer recognition of the income until it becomes determinable, subject to a 20% additional tax and interest at the underpayment rate plus 1%. Notice 2009-8 provides that a deferred amount will be treated as not determinable only if it would be treated as a "formula amount" under the proposed calculation regulations under Section 409A. These regulations set forth a narrow "indeterminability" exception for bonuses tied to future profits and similar payments based on amounts that remain variable until a particular date. Subject to the discussion above relating to the treatment of profits interests, investment funds that have not historically tried to defer performance fees, but which provide for "sidepocket" investments, may want to consider the impact of Section 457A(d)(1)(B) (which sets out special rules for compensation based solely on the amount of gain recognized on the disposition of an investment asset) and the foregoing provisions of the notice in their own particular situation.

Because Section 457A employs a narrow definition of substantial risk of forfeiture, Notice 2009-8 observes that the exception for short-term deferrals, which is otherwise identical to that of Section 409A, may expire earlier under Section 457A in certain circumstances. Section 457A also has a separate exception for deferred compensation that is paid to the taxpayer no later than 12 months following the close of the service recipient's taxable year in which the deferred compensation vested. While this rule may provide for a longer short-term deferral period than that the Section 409A period, Notice 2009-8 affirms that many forms of deferred compensation that would otherwise be subject to 457A will still have to comply with the narrower short-term deferral exception under Section 409A to avoid taxation under that section.

Notice 2009-8 also clarifies that once a taxpayer has included an amount of Section 457A deferred compensation in gross income, he will not be taxed again on the income at receipt.

Earnings on deferred compensation are treated as separate deferrals as long as the amount of the earnings is “reasonable” and the earnings are paid at least annually. Otherwise, the earnings are treated as currently deferred amounts. The notice does not give any guidance on how to determine where earnings are “reasonable.”

Effective Date and Transition Rules

Notice 2009-8 provides that Section 457A applies to any deferred compensation that is attributable to services performed by the taxpayer after December 31, 2008. Deferred compensation that would be subject to Section 457A except that it is attributable to services performed prior to January 1, 2009, will be included in gross income in the later of (a) the last taxable year beginning before 2018 or (b) the tax-able year in which there is no longer a substantial risk of forfeiture to the amounts deferred.

For purposes of determining whether an amount is grandfathered, amendments made to a plan after December 31, 2008, will generally be disregarded, except that the notice sets out a special transition rule allowing a plan to be amended retroactively to provide that a substantial risk of forfeiture that would otherwise lapse after December 31, 2008, will lapse before January 1, 2009, as long as the amendment is reduced to writing, adopted before July 1, 2009, and applied consistently to every service provider in the same arrangement or any substantially similar arrangement.

Notice 2009-8 provides that inclusion in income of deferred compensation under Section 457A will be treated as a payment exempt from Section 409A pursuant to the short-term deferral rule. Until final regulations are issued, the IRS will treat the inclusion of reasonable earnings under Section 457A, if distributed at least annually, as payments in accordance with a fixed schedule for purposes of Section 409A. Transition rules are in effect for 2008 and 2009 so that amendments to bring nonqualified deferred compensation plans into compliance with Section 457A will not have an adverse effect on compliance with Section 409A.

IRS Extends Favorable Stock Dividends Guidance to RICs

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In December 2008, the Internal Revenue Service (the “IRS”) issued Revenue Procedure 2008-68, providing temporary guidance regarding certain stock distributions by publicly traded real estate investment trusts (“REITs”). The taxpayer-favorable guidance gave publicly traded REITs greater flexibility to satisfy their tax-related distribution requirements while conserving cash in an illiquid market. On January 7, 2009, the IRS issued Revenue Procedure 2009-15 (the “Procedure”), extending its prior guidance to publicly traded regulated investment companies (“RICs”). Effective January 1, 2008 and for taxable years ending on or before December 31, 2009, the IRS will treat a distribution of stock by a publicly traded REIT or RIC pursuant to certain elections to receive stock or cash as a taxable distribution of property. The Procedure only applies to a REIT or RIC publicly traded on an established U.S. securities market. The amount of the stock distribution will be treated as equal to the amount of cash that could have been received instead. Under the Procedure, REITs and RICs can limit the aggregate amount of cash available to shareholders pursuant to the election to 10 percent of the aggregate distribution of cash and stock taken together. Given the requirement that a REIT or RIC be publicly traded on an established securities market, the Procedure generally will not apply to open-end mutual funds, and will only apply to ETFs and closed-end funds that are traded on a U.S. exchange rather than in the over-the-counter market.

Under the Internal Revenue Code (the “Code”), REITs and RICs must distribute to their shareholders each year their taxable income to minimize the imposition of taxes. Only taxable distributions of property satisfy this distribution requirement. Although a REIT or RIC might normally distribute cash to its shareholders, given current market conditions and liquidity constraints, REITs and RICs can conserve capital through taxable distributions of stock. While pro rata distributions of stock to shareholders often are nontaxable, under Section 305(b)(1) of the Code such distributions become taxable when shareholders have the option to elect between receiving stock or cash. REITs and RICs have sometimes relied on this Code provision to issue taxable stock distributions intended to count favorably toward satisfaction of the tax-related distribution requirements. In some instances, the aggregate amount of cash available pursuant to such an election has been limited, for example, so that the maximum cash payable could not exceed 20 percent of the aggregate distribution of cash and stock taken together.

Among other things, limiting the amount of cash available pursuant to a cash-or-stock election casts some doubt on the application of Section 305(b)(1), particularly when the limit is

low. The IRS has issued a number of favorable private letter rulings to REITs addressing 20 percent cash limitations. Provided the distribution falls within its strictures, the Procedure temporarily obviates the need to seek such rulings and allows a more generous 10 percent cash limitation.

In pertinent part, the Procedure provides a distribution of stock by a publicly traded REIT or RIC to its shareholders will be considered a taxable distribution of property in an amount equal to the amount of cash that could have been received instead if:

- Each shareholder may elect to receive its distribution in cash or stock of equivalent value subject to a limitation on the aggregate amount of cash to be distributed to all shareholders (the “Cash Limitation”), provided (a) such Cash Limitation is not less than 10 percent of the aggregate declared distribution and (b) if too many shareholders elect to receive cash, each shareholder electing to receive cash will receive a pro rata amount of cash corresponding to its respective entitlement under the declaration, but in no event will any shareholder electing to receive cash receive less than 10 percent of its entire entitlement in cash.
- The calculation of the number of shares to be received by any shareholder will be determined, as close as practicable to the payment date, based upon a formula utilizing market prices designed to equate in value the number of shares to be received with the amount of cash that could be received instead.

With respect to any shareholder participating in a dividend reinvestment plan (“DRIP”), the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in cash.

REITs and RICs should note the Procedure does not address the “preferential dividend” rules of the Code, which must be considered prior to relying on taxable stock distributions to meet their distribution requirements. Furthermore, restrictions under the Investment Company Act of 1940 may apply to the issuance of any stock distributions by a RIC.

Temporary Regulations Close Repatriation Loophole in Stock Transfers to Foreign Corporations

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On February 10, 2009, the Internal Revenue Service (IRS) issued temporary regulations (“Temporary Regulations”) on the application of Section 367 of the Internal Revenue Code (“Code”) in cross-border stock transfers governed by Code Section 304. The Temporary Regulations are intended to stop a transaction used by some taxpayers to repatriate cash to the United States tax-free and address an aspect of that transaction, which takes place under Code Section 304, previously addressed in 2006 final regulations. The Temporary Regulations apply to transfers or distributions on or after Feb. 11, 2009.

Background

Code Section 367(a)(1) generally provides that if a U.S. person transfers property to a foreign corporation in certain tax free exchange provisions (including Code Section 351), the foreign corporation will not be considered a corporation for purposes of determining the extent to which the U.S. person recognizes gain on such transfer. Code Section 367(b)(1) provides that in the case of certain exchanges (including Code Section 351) in connection with which there is no transfer of property described in Code Section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations.

Code Section 304(a)(1) generally provides that, for purposes of Code Section 302 and 303, if one or more persons are in control of each of two corporations and, in return for property, one of the corporations (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from the person(s) in control, then such property shall be treated as a distribution in redemption of the stock of the acquiring corporation. To the extent Code Section 301 applies to the distribution, the transferor and the acquiring corporation are treated as if (1) the transferor transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which Code Section 351(a) applies and (2) the acquiring corporation then redeemed the stock it is deemed to have issued. Under Code Section 304(b)(2), the determination of the amount of the property distribution that is a dividend is made as if the property is distributed by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits.

In early 2006, the IRS issued final regulations providing that Code Sections 367(a) and (b) would not apply to certain transfers of stock of a foreign or domestic corporation to a foreign acquiring corporation to which Code Section 351 applies by reason of Code Section 304(a)(1). These regulations were premised on the supposition that the policies under Code Sections 367(a) and (b) were preserved, even if a deemed Code Section 351 exchange was not subject to Code Sections 367(a) and (b), because generally the income recognized by the transferor in the

transaction (dividend income, capital gain or both) should equal or exceed the built-in gain in the transferred stock. Essentially, the IRS turned off Code Sections 367(a) and (b) to the deemed Code Section 351 transaction. However, taxpayers maintained that a transferor would not recognize income equal to or greater than the built-in gain in the transferred stock if, under Code Section 301(c)(2), the transferor was permitted to recover the basis of shares of the foreign acquiring corporation held before (and after) the transaction. As a result, the IRS has turned back on the Code Section 367 regulations in situations in which basis in previously owned shares is used.

The Basic Transaction

The 2006 final regulations discussed a transaction in which a U.S. parent sells a subsidiary (domestic or foreign) to a foreign acquiring subsidiary. For example, a domestic corporation (USP) owns all of the stock of each of two foreign corporations, FC1 and FC2. The stock of FC1 has a basis in USP's hands of \$0x and a fair market value of \$100x. The stock of FC2 has a basis and a fair market value of \$100x. Neither FC1 nor FC2 has earnings and profits. USP sells the stock of FC1 to FC2 for \$100x in cash.

This sale sets in motion several Code sections as discussed above. Under Section 304(a)(1), USP is deemed to have transferred the FC1 stock to FC2 in exchange for FC2 stock in a transaction to which Code Section 351 applies, and then FC2 is considered to have redeemed the stock deemed issued to USP for the \$100x paid. In the 2006 final regulations, the IRS maintained that the \$100x gain is taxable because there was no tax basis to recover in the stock of FC1. However, taxpayers argued that USP had no gain from the \$100 payment because it could reduce the basis of the FC2 stock that USP already owned prior to the transfer of the FC1 stock. Without more, USP would have repatriated a total of \$100x tax free.

The Temporary Regulations

The Temporary Regulations Section 1.367(a)-9T modify the application of Code Sections 367(a) and (b) to the deemed Code Section 351 exchanges by providing an exception to the general rule. For situations in which a distribution received by an exchanging shareholder would reduce (in whole or in part) the basis of stock of a foreign acquiring corporation that was held by a U.S. person before the transaction - other than the stock deemed issued to the U.S. person in the deemed Code Section 351 exchange - the U.S. person recognizes gain under Code Section 367(a)(1) equal to the amount by which the gain realized by the U.S. person with respect to the transferred stock in the deemed Code Section 351 exchange exceeds the amount of the distribution received by the U.S. person in redemption of the foreign acquiring corporation stock that is treated as a dividend under Code Section 301(c)(1) and included in the U.S. person's gross income under Treas. Reg. Section 1.367(a)-9T(b). Moreover, the exceptions to the application of Code Section 367 provided in the regulations will not apply to situations covered by the Temporary Regulations. For example, a U.S. person cannot avoid gain recognition under the Temporary Regulations by entering into a gain recognition agreement with respect to the deemed Section 351 exchange.

Accordingly, the repatriation opportunity presented by the scarcity of offshore earnings and profits is rendered much less attractive in light of the fact that USP must report taxable income in connection with the extraction of the \$100x from FC2.

Although Changes in Law are Possible, Changes to Fund Compensation Structures are Premature

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Since the first publication of this article, President Obama has announced in his budget proposal for Fiscal Year 2010 his support for carried interest being taxed at ordinary income rates, beginning in 2011; however, the authors of this article believe that the message expressed here still stands.

Recent press articles suggest that private investment fund sponsors should restructure the way “carried interest” is paid in their funds in order to avoid or lessen the impact of potential changes in tax law previously announced by President Barack Obama. In our view, any such changes are premature and could lock fund sponsors into adverse economic arrangements or have adverse tax effects if implemented before any such legislation is passed.

Overview of Proposed Changes

President Obama has indicated that he would support increased taxes on carried interest in line with legislation proposed by Rep. Sander Levin (D-MI). Rep. Levin’s bill generally treats carried interest as ordinary income to the recipient, regardless of the underlying character of the income that generated the carried interest. The bill contains limited exceptions which would not apply to the vast majority of funds, as they are currently structured. Subsequently, Rep. Charles Rangel (D-NY) introduced legislation containing provisions similar to (and more restrictive than) Rep. Levin’s bill. Neither bill was acted upon by the Senate. It is possible, given the current composition of Congress, that a bill similar to one of these bills will be reintroduced in Congress in 2009; however, given the current economic environment, it is uncertain what appetite Congress and President Obama will have in the short-term for tax raises.

Summary of Recently Publicized Proposals

Recent press coverage has identified at least two changes to fund structures suggested by certain practitioners to neutralize changes similar to those proposed in Rep. Levin’s bill. It should be noted, however, that neither suggested approach would be viable under the legislation introduced by Rep. Rangel.

Loan Approach. The first approach would require limited partners in funds (or perhaps the fund itself) to loan the carried interest recipient (typically the general partner of a fund), on a nonrecourse basis, an amount equal to the carried interest percentage of the fund’s capital (typically 20 percent of capital). The fund sponsor would then invest into the fund the loaned capital. The concept is that the carried interest would be converted from a profits interest, earned on limited partner capital, into a return on the fund sponsor’s invested capital (loaned to it by the

limited partners), a return which would be exempted from Rep. Levin's bill (but not from Rep. Rangel's bill). This loan would need to carry adequate interest, which the fund sponsor would be required to pay on a current basis (otherwise, income would be imputed to the fund sponsor).

This approach could work under Rep. Levin's bill, at least on a superficial basis; however, the loan would need to be a bona fide loan for tax purposes, which generally would require (among other things) that the fund sponsor has sufficient assets for the limited partners to reasonably expect repayment. In addition, fund sponsors would need to include income on a current basis and would not necessarily be entitled to a deduction for interest paid on such a loan, even if the invested loaned capital were ultimately lost.

Finally, as discussed above, Rep. Rangel's bill would appear to eliminate this planning opportunity. Of course, it is impossible to know at this time whether any legislation would resemble Rep. Rangel's or Rep. Levin's proposed legislation.

Offshore Approach. The second approach involves either establishing an offshore corporation through which the fund sponsor holds its carried interest or organizing the actual investment fund as an offshore corporation. Typically this corporation would be located in a low- or no-tax jurisdiction. There are many variations on this structure, some of which require minority US ownership to avoid another set of punitive tax rules applicable to so-called "controlled foreign corporations". Other such structures would require payment of carried interest as a fee, rather than as an allocation of profits. Such structures could result in deferral of tax, and, in certain unique circumstances, retention of capital gains treatment for carried interest; however, such structures could require significant changes to funds' operating procedures (including in some cases relocation of significant personnel outside the United States) or would require fund sponsors to keep cash proceeds from the carried interest outside the United States for a significant period of time (we note in this regard that we have seen in press articles advocacy of organizing the investment fund as a "passive foreign investment company"—however, under Rep. Rangel's bill, such an approach would not result in capital gains treatment for carried interest).

Depending on the form final legislation takes, there may be other approaches fund sponsors could take to restructure the way in which carried interest is paid in their funds to ensure continuing capital gains treatment for the carried interest or to otherwise mitigate the tax effects of legislation. In our view, however, implementing these, or the approaches discussed above, is premature at this point. First, the form of any legislation on carried interest is unknown at this time and the available planning approaches will differ dramatically depending on whether such legislation tracks Rep. Levin's proposal or Rep. Rangel's proposal. Second, it is arguable whether any legislation will be enacted in the short-term, given the current economic climate. Third, the approaches outlined above, as well as other possible alternatives, if implemented today, would lock fund sponsors into immediate tax (in the case of the loan structure) or inflexible structures requiring ongoing maintenance and potentially moving personnel offshore (such as the offshore structure).

Conclusion

It is premature to reorganize fund structures today in light of the tremendous uncertainty concerning the new administration's legislative priorities and the effect of the economic crisis on those priorities and the details of legislation that will emerge. While it could be prudent to adopt some of the structures discussed above if legislation similar to Rep. Levin's bill were enacted, at this point nobody knows with any degree of certainty, what, if any, legislation will be enacted in 2009.

How the Attorney Work Product Doctrine Can Protect Tax Accrual Workpapers from IRS Summons

Editor's Note: As we were going to press (March 25), the First Circuit vacated its decision in Textron and scheduled an en banc hearing for June 2. Nevertheless, the practical advice set forth in this article remains valid and important.

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In this IRS summons case, the Court of Appeals for the First Circuit, one judge dissenting, ruled that Textron's tax accrual workpapers are attorney work product and are protected against forced disclosure to the IRS.

The appeals court, however, remanded the case to the district court to consider whether Textron must produce the tax accrual workpapers that Ernst & Young ("E & Y") prepared and still holds. The remand potentially threatens the protection against disclosure of the very Textron tax accrual workpapers that the First Circuit's opinion protects for now.

What the Court of Appeals Held

The First Circuit held that because "the function of the documents" – of the tax accrual workpapers that Textron prepared - "was to analyze litigation for the purpose of creating and auditing a reserve fund," it follows that Textron prepared those workpapers "because of" the prospect of litigation. It is irrelevant that Textron also prepared the workpapers to comply with financial reporting obligations because a "dual-purpose" document may be work product. Hence, the workpapers are work product.

The appeals court also held that Textron did not waive work product protection by disclosing its tax accrual workpapers to E & Y, because E & Y was not an actual or potential adversary of Textron. (That disclosure waived the attorney-client privilege, however, and so this case is about work product only.)

Remanded to the District Court

The First Circuit remanded the case to the district court to consider whether Textron must produce the tax accrual workpapers that E & Y prepared and still holds. To avoid a duty to produce the E & Y workpapers to the IRS, Textron must show that it lacks "control" over those papers. Such "control" exists only if E & Y must turn over its workpapers to Textron upon demand.

In a roundabout way, the remand also threatens the protection of the tax accrual workpapers that Textron prepared and the First Circuit protects for now. If the district court rules that Textron controls the E & Y workpapers and must produce them, then the district court also

must ascertain whether the E & Y workpapers reveal Textron's own tax accrual analysis. If so, then, when Textron disclosed its tax accrual workpapers to E & Y, Textron possibly waived work product protection for them.

What Next for Textron?

The question is whether this case first goes down to the district court on remand, or it first goes up to the Supreme Court for review. The IRS might well successfully press the Solicitor General to authorize the United States to petition the Supreme Court to review one or more of the First Circuit's holdings. The United States likely will frame the question for review as whether the First Circuit erred in ruling that the work product doctrine protects Textron's tax accrual workpapers. Less likely, the United States might also ask the Court to review the question whether a financial auditor is a potential adversary (so that disclosing the tax accrual workpapers to E& Y waived work product protection).

If the United States does petition the Supreme Court, then because of the administrative importance of the issue and the conflict between the First Circuit's opinion and the Fifth Circuit's opinion in *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982) (declining to protect tax accrual workpapers as work product), the Supreme Court's granting of the petition becomes a real prospect.

Welcome as this opinion is to taxpayers, it is too soon to rack up certain victory for Textron. Historically, in IRS summons cases, the Supreme Court has more often favored the United States. This litigation over Textron's tax accrual workpapers is not over.

Implementing the Lessons of Textron

While Textron involves an IRS summons, perhaps an equally important application of this case would prevent examinations of work product by state taxing authorities. The IRS has a long-standing "policy of restraint" limiting the examination of tax accrual workpapers unless the taxpayer has engaged in one or more of the maligned "listed transactions." However, the vast majority of state taxing authorities have no such announced policy. Moreover, states are becoming more aggressive as they perceive the erosion of their corporate tax base by sophisticated multi-state strategies.

To sustain the defense of the work product doctrine (and of the attorney client privilege, where appropriate) to the compelled disclosure of confidential tax information, plan ahead. That is, before even preparing that information, make the effort to bring it within the scope of the work product doctrine. Arguments for protecting documents that are thought-up only after they are prepared typically fail.

Conclusion

In summary, Textron's defense against the IRS summons benefited from the following favorable facts, which are worth emulating:

- Use tax lawyers to create the work product. To be sure, “work product” need not be attorney work product, so long as it is prepared in anticipation of litigation or for trial. However, it is much easier to show that tax accrual work papers are work product when a tax attorney, or a person working for the tax attorney, prepares it.
- As in Textron, have the tax lawyers review proposed transactions and, well prior to preparing tax accrual workpapers, identify the risky tax issues, write the memoranda of law and fact, and assess the prospects for success in litigation.
- Document the requirement that the auditor, to whom the tax accrual workpapers are disclosed, must keep them confidential.
- Although the auditor must review the taxpayer’s tax accrual workpapers, do not allow the auditor to retain a copy.
- Do not disclose the tax accrual workpapers to any other third parties.
- Privileged communications and work product aside, cooperate with the IRS by furnishing all other requested information.
- Keep business and transactional records out of the tax accrual workpapers, which ideally should consist only of tax counsel’s memoranda regarding the litigation hazards of doubtful tax positions.

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