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Dear ,

This issue of the WKBK&Y newsletter addresses:

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1. Tax Accrual Workpapers Held Protected by Work-Product Privilege

Introduction

The First Circuit recently issued an opinion that a public company’s “tax accrual workpapers,” which list questionable tax positions taken on a tax return, estimate the likelihood of success of such positions, and calculate the amount of additional tax liability that would result from the revisions of those positions, are protected from IRS discovery under the work-product privilege. In addition, the taxpayer’s disclosure to its independent auditor did not constitute a waiver of the privilege. The case is United States v. Textron, Inc., 2009 U.S. App. LEXIS 1538 (January 21, 2009).

Work-Product Privilege

The work-product privilege protects from discovery “documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative.” (Fed. R. Civ. P. 26(b)(3)(A).) The First Circuit uses the “because of” test; under this test, a document is protected “if, in light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation.” (Maine v. US Dept. of Interior, 298 F.3d 60, 70 (1st Cir. 2002).)

However, the “because of” standard does not protect from disclosure documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation. (*Id.*) The term “litigation” in this context is construed broadly and includes anticipation of audit disputes can constitute anticipation of litigation. (*US v. Roxworthy*, 457 F.3d 590, 600-01 (6th Cir. 2006).)

Facts

The taxpayer, Textron, Inc. (“Textron”), is a publicly traded corporation. Federal securities laws require publicly traded companies to obtain a letter from an independent auditor approving the company’s financial statements, and that part of the audit was an analysis of the company’s reserves for cover the loss. Accordingly, Textron prepared tax accrual workpapers to substantiate Textron’s anticipated likelihood of success on its tax positions and to establish to the auditor that it was adequately reserved with respect to any potential disputes or litigations that would happen in the future. Textron’s attorneys analyzed each potentially questionable tax position and estimated a percentage of success if challenged by the IRS. The reserve was calculated by multiplying this percentage by the tax benefit claimed.

Textron identified the likelihood of success as 0% for a number of issues in cases where a subsequent legal development rendered a prior position indefensible. Textron anticipated it would concede these issues on audit.

Ernst & Young (“E&Y”) was Textron’s auditor. E&Y was permitted to look at Textron’s tax accrual workpapers but was not permitted to retain a copy of them.

The IRS subpoenaed Textron’s tax accrual workpapers, and Textron asserted work-product privilege barred IRS discovery of the workpapers. The IRS also subpoenaed E&Y’s audit workpapers.

Analysis

The district court held a hearing to determine whether and to what extent Textron’s tax accrual workpapers were discoverable by the IRS. The district court found that Textron’s ultimate purpose in preparing the tax accrual workpapers was to ensure that it was adequately reserved with respect to any potential disputes or litigation that would happen in the future. The district court held that the workpapers would not have been prepared at all but for the fact that Textron anticipated the possibility of litigation with the IRS. Further, the court reasoned that there would have been no need for such reserves if Textron did not anticipate litigation or some other adversarial proceeding with the IRS.

In response to the IRS’s argument that Textron waived the privilege by disclosing to E&Y, the district court focused on the fact that E&Y was not an adversary and was bound by confidentiality. Thus, the disclosure did not substantially increase the IRS’s opportunity to obtain the information contained in the workpapers.

The First Circuit Court of Appeals agreed with the district court, holding the workpapers were prepared “because of” the risk of disputes and litigation gave rise to a need to compute and report tax reserves. That the workpapers also served the business purpose of complying with federal securities laws was not dispositive because the Circuit found that “dual purpose” documents created because of the prospect of litigation are protected even though they were also prepared for a business purpose. The majority ultimately reasoned that a holding that the workpapers were discoverable would lead to undesirable results in other cases—e.g., a document prepared to analyze a specific litigation to compute for an auditor how much should be retained in a reserve fund. In such a case, the opposing counsel in the litigation might be able to discover such a memo, which would effectively disclose the counsel’s mental impression of the case.

The IRS cited a Fifth Circuit opinion, US v. El Paso Co., 682 F.2d 530, (5th Cir. 1982), for the opposite conclusion. The Court discounted the relevance of El Paso, however, because the Fifth Circuit uses a different definition of the work-product doctrine, instead asking whether the primary motivating purpose behind the creation of the document was to aid in possible future litigation. In contrast, the First Circuit uses the “because of” test cited above.

Regarding E&Y’s audit workpapers, the issue hinged on whether Textron had the right to demand E&Y’s workpapers. In US v. Arthur Young & Co., 465 US 805 (1984), the Supreme Court held that while an independent auditor’s workpapers are protected under work-product privilege to the extent that they represent the taxpayer’s own mental impressions, opinions, etc. But if instead the auditor is applying its independent professional judgment, then such workpapers would not be so protected. E&Y’s officer testified that E&Y’s workpapers were created using E&Y’s own independent judgment. However, because E&Y was not a defendant to the action, the First Circuit Court of Appeals remanded the issue to the district court to determine the extent to which Textron had the right to demand E&Y’s workpapers from it (and thus would be deemed to have control of them).

WKBKY Takeaway

Textron is a valuable decision because it protects the taxpayer’s mental impressions regarding the viability of a particular reporting position from discovery by the IRS even where prepared for reasons in addition to impending adversarial proceedings. Notwithstanding, there is some risk because the circuits have differing definitions of what the work-product is defined to protect. Furthermore, the case illustrates that the privilege does not extend so far as to protect an auditor’s own opinions or mental impressions.

2. Ex-Spouse Beneficiary Still Entitled to ERISA Benefits

The Supreme Court has ruled that a plan administrator need only look to the plan documents to determine who is owed benefits. With certain limited exceptions, documents or agreements outside of the plan do not bear on the administrator’s obligations. The case is Kennedy v. Plan Adm’r for DuPont Sav. & Inv. Plan, 128 S. Ct. 1225 (2008).

Facts

In Kennedy, the decedent, William Kennedy, was a participant in his employer's savings and investment plan (the "Plan"). During his marriage to Liv Kennedy, he named her as beneficiary to his benefits under the Plan but named no contingent beneficiary. The couple divorced, and the divorce decree divested Liv of all rights to any benefits to William under the Plan. But William did not execute any Plan documents removing Liv as beneficiary. Liv was the beneficiary when William died. The Plan administrator paid William's benefit to Liv; the executrix of William's estate sued the Plan and its administrator for William's retirement benefit.

Law

ERISA generally provides that benefits under a qualified plan are neither alienable nor assignable. One exception exists for a court order that satisfies certain statutory requirements, known as a qualified domestic relations order ("QDRO").

Issues

Prior to resolution of the Supreme Court case, a split of authority existed among the circuits as to whether a divorced spouse can waive pension plan benefits through a divorce decree not amounting to a QDRO.

The Supreme Court also recognized a similar split of authority as to whether a beneficiary's federal common law waiver of plan benefits is effective where that waiver is inconsistent with plan documents.

Analysis

The Court decided that under ERISA, a divorcing spouse can waive plan benefits under state law. The Plan argued that the waiver was tantamount to an indirect assignment or alienation of the benefits. The Court held that the concepts of waiver and assignment are distinct and should not be read together.

Moving on from Liv's ability to waive her benefits under the Plan, the Court addressed the issue whether, notwithstanding Liv's waiver, the Plan administrator was required to honor the waiver. The Court held that the Plan did not, reasoning that the Plan administrator is only charged with administering the Plan pursuant to the Plan documents and ERISA. Because the Plan documents provided that Liv was the beneficiary, and because the divorce decree did not amount to a QDRO (subjecting the decree to ERISA's anti-alienability exception), the Plan administrator was required by ERISA to follow the beneficiary as designated in the Plan documents.

WKBKY Takeaway

The largest lesson to glean from this case is that qualified plan participants need to revisit their retirement plan beneficiary whenever there is a major life change, e.g., a divorce. This is

the only way to guarantee that a state divorce decree or any other document external to the plan are given their effect as far as administration of the plan under ERISA is concerned.

Even though the Court held that the administrator's payment to Liv was proper, it noted in a footnote that this would not necessarily prevent the estate from suing Liv for the Plan benefit in state or federal court. The Court cited in this footnote case law in support of this proposition. Notwithstanding, this would obviously cost the estate additional time and money to pursue, and there would be no guarantee that the beneficiary would even have the funds any longer.

In sum, the best practice is to ensure that beneficiary designations are revisited after a divorce, irrespective of what a divorce decree may say, to ensure that the distribution is made as intended at the outset.

On a larger scale, this case is important because of the fact that it resolves two separate splits in authority in ERISA law.

3. New Stimulus Package Signed into Law – Tax Provisions of the American Recovery and Reinvestment Act of 2009

WKBKY would like to report on the tax provisions contained in the American Recovery and Reinvestment Act (the "Act"). On February 17, 2009, the Act was signed into law by President Obama. In addition to a number of non-tax provisions, the \$787 billion bill contains numerous business and personal income tax incentives designed to stimulate the economy.

The following is a brief summary of some highlights of the tax provisions in the bill applicable to individuals and businesses.

ONE-YEAR AMT PATCH

Each year for the past few years, Congress and the incumbent President fix or "patch" the AMT. The patch is designed to raise the AMT exemption so that an estimated 26 million taxpayers would not inadvertently be subject to the tax. The Act, patches that AMT by raising the AMT exemption to \$70,950 for joint filers (up from \$69,950 in 2008) and \$46,700 for single or head of household filers (up from \$46,200).

INDIVIDUAL TAX INCENTIVES AND CREDITS

Car Buyer Incentives. The Act allows auto buyers an above-the-line income tax deduction for state and local sales taxes or excise taxes paid on purchases of new automobiles. It specifically excludes used car purchases and all leases. The deduction is completely phased-out at \$135,000 in modified adjusted gross income ("MAGI") for single individuals and \$260,000 for joint filers. This is effective only for purchases made from February 17 through December 31, 2009.

Changes to 529 Plans/Qualified Higher Education Expenses. In general, qualified higher education expenses withdrawn from a Section 529 College Savings Plan ("529 Plan") are

distributed income tax free if they are used for tuition, fees, books, supplies and equipment required for enrollment and attendance at a university or other postsecondary institution. For 2009 and 2010 only, the cost for computers and computer technology is an eligible “equipment” expense for higher education.

Modified Hope Education Tax Credit. The Act temporarily modifies the Hope credit by raising it from its prior amount of \$1,800 to \$2,500 for 2009 and 2010. This credit applies to students who pay qualified tuition and related expenses during the first four (up from two) years of post-secondary education in a degree or certificate program. The credit is 100% of the first \$2,000 of qualified tuition and expenses and 25% of the next \$2,000 of qualified tuition and expenses.

Changes to First-Time Homebuyer Credit. Last year, Congress passed the *Housing Assistance Tax Act of 2008*, which included a refundable tax credit up to \$7,500 for first-time homebuyers. If you took advantage of the credit, you were required to repay it to the government over 15 years. The Act modifies the credit in two ways. First, it increases the credit to \$8,000 (\$4,000 for a married taxpayer filing a separate return). Second, for purchases made between January 1, 2009 and December 1, 2009, repayment of the credit is waived provided the taxpayer lives in the home for three years from the date of purchase. The homebuyer credit is completely phased-out when your MAGI reaches \$95,000 for singles and \$170,000 for couples.

Home purchases made between April 9, 2008 and December 31, 2008 will not be eligible for the repayment waiver and the new credit limit.

Making Work Pay Credit. In general, lower and middle-income individual taxpayers will be eligible for a refundable credit, up to \$400 for singles and \$800 for couples, for 2009 and 2010. The credit will be completely phased-out if MAGI is \$95,000 for single filers and \$190,000 for married joint filers.

Economic Recovery Payment. A one-time payment of \$250 will go to individuals on fixed incomes, i.e., Social Security and Supplemental Security Income (SSI) beneficiaries, retired railroad workers, and disabled veterans for the last three months prior to enactment.

Transit Benefits Parity. If a taxpayer commutes to work via public transportation, van pooling, or qualified parking, s/he may enroll in his / her employer’s transportation fringe benefits plan, which allows the taxpayer to set aside pre-tax dollars up to a specific amount for transportation and parking expenses. The Act equalizes the parking and transit income exclusion amount limits by increasing the transportation limit from \$120 to \$230 per month starting in March 2009, subject to inflation adjustment through 2010.

INDIVIDUAL ENERGY INCENTIVES

Homeowners’ Energy Credit. Prior to the passage of the Act, homeowners making certain qualifying energy efficient improvements to their principal residence in 2009 would be entitled to a tax credit equal to either 10% of the cost of the improvements or a certain dollar amount. The maximum credit is \$500 per lifetime.

The Act increases this tax benefit in three ways: (1) the credit is extended through 2010; (2) the percentage of cost that can generate a credit has been increased to 30% for all properties; and (3) the lifetime \$500 cap has been replaced with a \$1,500 cap on the credit for the 2-year period 2009 through 2010.

Homeowners Energy Efficient Property Credit. There is also a separate credit for investing in certain energy efficient property such as (i) solar water heating, (ii) geothermal heating, (iii) fuel cell property, and (iv) wind. The credit is generally 30% of the costs, but there are caps on the credit available for each of these four types of alternative energy property. The Act removes the cap on the credit available for these alternative energy investments (except the credit for fuel cell property, which is capped at \$500 per kilowatt of capacity).

BUSINESS TAX INCENTIVES AND CREDITS

5 -Year Net Operating Loss (NOL) Carryback. In general, a business's NOL can be carried back up to 2 years to offset prior years' income. Under the Act, a small business (defined as a sole proprietorship, partnership, or corporation with average annual gross receipts under \$15 million) will be eligible to elect carryback of an NOL attributable to 2008 for up to 5 years. For purposes of the gross receipts test, gross receipts of multiple trades or businesses sharing at least 50% common ownership must be aggregated. For fiscal year taxpayers, this can be an NOL for a tax year ending in 2008 or beginning in 2008.

Gain from restructuring debt can be deferred. Under the Act, if a business restructures business debt in 2009 or 2010, the resulting cancellation-of-debt income can be deferred and taken into income ratably over 5 years beginning in 2014.

Extension of 50% Bonus Depreciation Deduction. A bonus depreciation deduction has been available since 2002. The 2008 stimulus package included a bonus depreciation deduction for most property placed in service (other than buildings) equal to 50% of the asset's basis. The Act extends this 50% bonus depreciation for another year for qualified business property placed in service in 2009. (The credit is extended through 2010 for qualifying property with a longer production period.) Furthermore this tax benefit is not added back for AMT calculations.

Increased Section 179 Deduction Limits. For small businesses, when tangible personal property is placed in service, much of the costs can be deducted up front. Under pre-Act law, the amount that could be deducted up front in 2009 and 2010 was scheduled to be \$133,000. After 2010 the amount that can be deducted is scheduled to be \$25,000. This up-front deduction is reduced by the excess of the total investment is over \$530,000 in 2009 or 2010; after 2010 the cap is \$200,000. For 2009, the Act increases the immediate write-off of expenses under Section 179 increases to \$250,000 and the investment cap to \$800,000.

Qualified Small Business Stock (QSBS). For stock owned by individuals in certain qualified business entities, part of the gain on the sale of the stock is excluded from income, although the remaining gain does not qualify for the 15% long term capital gain rate but rather is taxed at 28%. And there are AMT adjustments. Under existing law, this exclusion is subject to

many conditions, but generally the exclusion is 50% of the gain. Under the Act, for QSBS stock purchased directly from the company after the date of enactment and before January 1, 2011, 75% of the gain on a subsequent sale can now be excluded from gain for regular tax purposes.

S Corporation Built-In Gain. If a C corporation elects to become an S corporation, the corporation's built-in gain ("BIG") will be subject to two levels of tax if that gain is recognized during the 10 year period following the conversion. Under the Act, the 10-year holding period is reduced to a 7-year holding period for any BIG recognized in 2009 or 2010.

4. CODI & the Insolvency Exception – Exempt Assets Included in Insolvency Calculation under Code section 108

Introduction

In Carlson v. Comm'r., 116 T.C. 87 (2001), the Tax Court held that the taxpayer, a commercial fisherman, and his wife could not exclude cancellation of debt income ("CODI") from gross income under the Code's insolvency exclusion in Code section 108(a)(1)(B) because the taxpayers were not insolvent as that term is defined in the Internal Revenue Code. The Court held that the term "assets," as used in the Code's insolvency definition, includes assets exempt from creditors under state (and Bankruptcy) law. In so holding, the Court specifically rejected the Court's common law interpretation of the insolvency exception, which excluded assets from state creditors from the insolvency calculation.

Legal Background

Prior to enactment of Code section 108, the concepts of CODI and exclusions thereto were matters of common law. United States v. Kirby Lumber, 284 U.S. 1 (1931) stands for the "freeing of assets" concept of CODI recognition—in effect, because debt relief results in a freeing of the taxpayer's assets to the extent of the debt forgiven, the taxpayer recognizes income when the debt is canceled. In Dallas Transfer & Terminal Warehouse Co. v. Comm'r., 70 F.2d 95 (5th Cir. 1934), the Fifth Circuit reasoned that where a taxpayer is insolvent both before and after the discharge, the taxpayer experiences "a reduction or extinguishment of liabilities without any increase in assets" and held that without such an increase in assets, no income should be realized for purposes of taxation. In Lakeland Grocery Co. v. Comm'r., 36 B.T.A. 289 (1937), the Board of Tax Appeals further modified the insolvency exception to hold that a taxpayer who is insolvent immediately before the CODI but solvent as a result of the CODI will be taxed on the value of the assets "that ceased to be offset by liabilities." (The rule in Lakeland is now codified in section 108 because that section only allows CODI exclusion "to the extent of" the taxpayer's insolvency.)

Cases subsequent to Dallas Transfer and citing thereto have held that the net assets test for insolvency developed in the common law should exclude assets exempt from creditors. (See Hunt v. Comm'r., 57 T.C.M. (CCH) 919 (1989); Cole v. Comm'r., 42 B.T.A. 1110 (1940).) Though Hunt was decided after the insolvency exclusion was legislated by Congress, the discharge in that case occurred prior to the effective date of Code section 108(a)(1)(B).

Nevertheless, the Court in Hunt acknowledged in dicta that the assets included in the common law insolvency calculation comports with the section 108 insolvency exclusion.

In 1980, Congress enacted the insolvency exception of Code section 108(a)(1)(B). This section excludes CODI from income recognition to the extent that the CODI does not exceed the amount by which the taxpayer is “insolvent.” Section 108(d)(3) defines “insolvency” as “the excess of liabilities over the fair market value of assets ... on the basis of the taxpayer’s assets and liabilities immediately before the discharge.” The term “assets” for this purpose is not defined elsewhere in the Code, Regulations, or IRS interpretive rulings.

In contrast, Bankruptcy Code section 101(32) (successor to section 101(26)) is specific in excluding from the insolvency calculation property owned by the debtor “that may be exempted from property of the estate” under applicable bankruptcy law.

The Carlson Case

In Carlson, the taxpayers argued that the insolvency exception applied to exclude certain CODI from recognition. Their basis for this argument was that their assets which were exempt from creditors in bankruptcy should not be included in the tax law insolvency computation. The taxpayers relied on Hunt and the common law insolvency exception. The Court apparently did not like its dicta in Hunt, reasoning that Hunt was inapplicable to the case at issue because it was decided based on law in effect prior to the 1980 enactment of Code section 108(a)(1)(B).

Rejecting the common law analysis, the Tax Court in Carlson limited the application of the common law insolvency exception to the cases referred to in the legislative history to Code section 108(a)(1)(B). The cases cited in the legislative history merely document the common law exception and development of the insolvency exclusion but fails to mention the cases excluding exempt assets from the insolvency calculation. Moreover, the Court reasoned that Congress’ decision to define insolvency in the Bankruptcy Code by excluding the exempt assets should be contrasted with Congress’ decision not to include such an exclusion in the Internal Revenue Code. It inferred the distinction as reflecting Congress’ deliberate intention to include exempt assets under the tax law insolvency test. Instead, the Court interpreted the word “assets” according to its plain meaning, interpreting that term as referring to all assets of the taxpayer.

Accordingly, the Court held that the taxpayers’ assets exempt from creditors must nonetheless be included in the determination of insolvency for purposes of the Code section 108(a)(1)(B) exclusion rule.

WKBKY Takeaway

Carlson was decided eight years ago. While it ruffled some feathers among practitioners immediately following the decision, it has subsequently been cited favorably by the Tax Court and there has not been any serious legal challenge to the case to indicate that it should be afforded any less than full effect. Without amendment to Code section 108 by Congress or an appeal of this rule to a higher court, Carlson will require taxpayers seeking to utilize the

insolvency exclusion to CODI to include assets exempt from creditors in their insolvency calculation.

Arguably, Carlson does not comport with the policy of Code section 108 that individuals outside of bankruptcy should be given a “fresh start” and should not be immediately burdened with tax liability. As a result of the decision, taxpayers might be forced to liquidate assets exempt from creditors under state law to pay federal income tax.

An important note is that a taxpayer whose debts are discharged in bankruptcy is allowed a full exclusion of any CODI attributable to such discharge, irrespective of any insolvency analysis. Bankruptcy CODI is subject to its own exclusion, section 108(a)(1)(A), which excludes from recognition all CODI attributable to bankruptcy discharge.

We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.

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