XVI. Taxation and Accounting

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A. Introduction

This report reviews significant tax law developments relevant to practice of public utility, communications, and transportation law. On March 23, 2010, President Barack Obama signed the Patient Protection and Affordable Care Act (PPACA)[1] into law. One week later, he signed the Health Care and Education Rec-

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1. H.R. 3590, Pub. L. No. 111-148, 111th Cong. (2010).

onciliation Act of 2010 (Reconciliation Act),[2] which amends various provisions of the PPACA and adds some new ones. This article refers to the PPACA and the Reconciliation Act collectively as the Act. The intent of the Act is to increase the number of Americans who have access to health care. To defray some of the costs, the Act includes tax increases on high-income individuals, excise taxes on high-cost group health plans, and new fees on selected health care related industries, which are together projected to raise $400 billion over ten years. Some of the more significant tax provisions are summarized below.

President Obama also signed H.R. 2847, the Hiring Incentives to Restore Employment Act (HIRE) on March 18, 2010,[3] which contains two provisions designed to promote the hiring and retention of employees. On November 6, 2009, he signed the Worker, Homeownership, and Business Assistance Act of 2009 (WHBA),[4] which provides an election for most businesses to increase the carryback period for either their 2008 or 2009 net operating losses (NOLs) from two years to up to five years.

This report covers the possible tax issues and tax treatment that may result from cap and trade legislation introduced in the U.S. House of Representatives on June 26, 2009. It also includes a summary of guidance that has been released regarding certain tax credit and grant provisions included in the American Recovery and Reinvestment Act of 2009 (ARRA). It discusses the First Circuit's decision in *Textron Inc. v. United States* regarding tax accrual workpapers and provides a description of considerations to protect privilege with respect to tax related materials. Finally, we cover changes in accounting method for repairs and maintenance costs and the tax treatment of smart grid grants.

B. Tax Legislation

1. Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act

a. Codification of Economic Substance Doctrine

The Act codifies the doctrine of economic substance and thereby provides a uniform statutory definition of economic substance. The provision mandates that whenever economic substance is relevant to a transaction, the transaction will be treated as having economic substance only if: (1) the transaction changes in a meaningful way the taxpayer's economic position other than the federal income tax effects; and (2) the taxpayer has a substantial business purpose other than federal income tax effects for entering into the transaction. The law requires a 20 percent penalty on the amount of a tax underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance. The penalty is increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment of the transaction. There is

2. H.R. 4872, Pub. L. No. 111-152, 111th Cong. (2010).
3. H.R. 2847, Pub. L. No. 111-147 (2010).
4. Pub. L. No. 111-92.

no reasonable cause exception to the penalties. Accordingly, outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty. The provision is effective for transactions entered into after March 30, 2010.

b. New Tax on Investment Income

Beginning in 2013, the Act imposes a new 3.8 percent surtax on certain unearned income. In the case of an individual, the tax is 3.8 percent of the lesser of: (1) net investment income; or (2) modified adjusted gross income[5] in excess of $250,000 for a married couple filing a joint return; $125,000 for a married individual filing a separate return; and $200,000 for other taxpayers. In the case of an estate or trust, the 3.8 percent tax applies to the lesser of: (1) undistributed net investment income; or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins (currently $7,500).

For these purposes, net investment income generally means the excess of: (1) the sum of (x) gross income from interest, dividends, annuities, royalties, rents, gain on a disposition of an asset, in each case other than in connection with a trade or business to which the tax does not apply, and (y) other gross income derived from certain businesses in which the taxpayer is a passive investor or that are financial instrument or commodities trading businesses; over (2) deductions properly allocable to such income.

c. Increase of FICA Taxes on Wages and Self-Employment Income

Effective for tax years beginning after December 31, 2012, the Act increases the health insurance tax (i.e., Medicare tax) by 0.9 percent on wages received in excess of $250,000 for a married couple filing a joint return, $125,000 for a married individual filing a separate return, and $200,000 for other taxpayers. The additional 0.9 percent tax increases an employee's portion of hospital insurance tax on wages in excess of the threshold amount from 1.45 percent to 2.35 percent. The employer's portion of the tax remains at 1.45 percent.

The additional health insurance tax of 0.9 percent will also be imposed on every self-employed individual whose net self-employment income exceeds the threshold amounts described above. The additional 0.9 percent tax increases the current rate of hospital insurance tax on self-employment income from 2.9 percent to 3.8 percent. Generally, 50 percent of the hospital insurance tax is deductible on the income tax return of the self-employed individual. However, this deduction will not be available on the additional health insurance tax of 0.9 percent.

d. Increase of Itemized Deduction Threshold

Beginning January 1, 2013, the Act increases the threshold for the itemized deduction for unreimbursed medical expenses from 7.5 percent of adjusted gross

5. "Modified adjusted gross income" means adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1).

income (AGI) to 10 percent of AGI for all taxpayers under sixty-five. The increased threshold is effective for all taxpayers beginning in 2017.

e. Excise Taxes Imposed on So-Called Cadillac Group Health Plans

New Internal Revenue Code section 4980I imposes an excise tax on a health insurance issuer if the aggregate cost of coverage of employer-provided health care for an employee or former employee exceeds $10,200 for an individual and $27,500 for a family, with higher thresholds applicable to retirees over fifty-five and employees in certain high-risk professions. The tax is nondeductible and is equal to 40 percent of the excess of the aggregate cost of coverage over the threshold amounts. The threshold amounts will be indexed for inflation. Although the tax is generally levied on the health insurance issuer, if the applicable employer provider coverage consists of employer contributions to a health or medical savings account, the employer is liable for the tax. The provision is effective for tax years beginning after December 31, 2017.

f. Additional Reporting for Employers on Form W-2

Beginning in tax years that begin after December 31, 2010, employers will be required to disclose on each employee's Form W-2 statement the aggregate cost of employer-sponsored health benefits. The reported aggregate costs of health benefits on the Form W-2 will be the same amount used to determine the tax on the so-called Cadillac health plans discussed above.

g. Industry Fees Assessed on Health Insurance Providers and Branded Drug Manufacturers and Importers

The Act provides for new fees to be levied on companies engaged in the business of providing health insurance with respect to United States health risks and companies engaged in the business of manufacturing or importing branded prescription drugs for sale to any specified government program or pursuant to coverage under any such program. The aggregate annual fee imposed on each of the two industries is the set dollar amount presented in the following paragraph. That amount is apportioned among the companies in an industry based on their respective market shares within the industry during the prior year. The fees become payable for drug manufacturers and importers with calendar years beginning with 2011, and for health insurance providers with calendar years beginning with 2014.

For branded drug manufacturers and importers, the applicable fee is $2.5 billion for calendar year 2011; $2.8 billion for calendar years 2012 and 2013; $3 billion for calendar years 2014 through 2016; $4 billion for calendar year 2017; $4.1 billion for calendar year 2018; and $2.8 billion for calendar year 2019 and thereafter. For health insurance providers, the fee is $8 billion for calendar year 2014; $11.3 billion for calendar years 2015 and 2016; $13.9 billion for calendar year 2017; and $14.3 billion for calendar year 2018. For calendar years after 2018, the applicable fee is indexed to the rate of premium growth.

h. Limitation on Deductibility of Executive Compensation for Health Insurance Providers

The Act limits the deduction for remuneration to each individual officer, employee, director, and service provider (such as an independent contractor) of covered health insurance providers to $500,000 per year. The limitation applies to both current and deferred compensation. An insurance provider is a covered health insurance provider if it receives at least 25 percent of its gross premium income from health insurance plans that meet certain minimum requirements. The provision is effective for compensation paid in taxable years beginning after December 31, 2012, with respect to services performed after 2009.

i. Prohibition of Black Liquor under Section 40(b)

The Act precludes "black liquor" from eligibility for the cellulosic biofuel producer credit. Black liquor is a liquid material that is a byproduct of the papermaking process and has been used for decades by paper manufacturers as a fuel. When Congress created a tax credit in 2005 for alternative fuel derived from biomass, paper producers became eligible to claim the credit as a result of the use of black liquor to create energy. The new provision making black liquor ineligible for the credit became effective for fuels sold or used after December 31, 2009.

j. Mandate for Employers to Insure Employees or Pay Penalties

Employers with at least fifty full-time employees will be subject to nondeductible fees if they do not offer health insurance coverage to employees. The fee generally equals $2,000 multiplied by the number of full-time employees of the company in excess of the first thirty full-time employees, which are not counted in the payment calculation. In addition, an employer with at least fifty employees that does not offer certain levels of cost-sharing or reimbursement benefits will be subject to an annual $3,000 penalty for each of its employees that qualifies for and obtains government-subsidized coverage. This provision is effective beginning after December 31, 2013.

2. Hiring Incentives to Restore Employment Act

a. Employers Exempted from Paying Their Share of Social Security Taxes

Employers are exempt from paying the employer share of social security taxes (6.2 percent for the first $106,800 of wages) for wages paid to eligible employees in 2010. "Eligible employees" generally include any employee who: (1) is hired after February 3, 2010, and before January 1, 2011; (2) was not employed for more than forty hours during the sixty-day period ending on the date his or her new employment begins; and (3) does not displace another employee of the employer unless the employee left voluntarily or for cause.

b. Employer Incentivized to Retain New Hires

A new business tax credit is available to employers that retain new hires. To qualify for the credit, a company must hire an employee after February 3, 2010,

and before January 1, 2011, and that employee must stay on the job for at least fifty-two consecutive weeks. Furthermore, the employee must be paid an amount during the last twenty-six weeks of the fifty-two consecutive weeks equal to at least 80 percent of the amount he or she was paid during the first twenty-six weeks. The credit equals the lesser of $1,000 or 6.2 percent of the wages paid to the retained employee during the fifty-two week period. For calendar year taxpayers, the credit would be claimed on the employer's 2011 tax return because of the fifty-two consecutive week requirement.

3. Worker, Homeownership, and Business Assistance Act

a. Expansion of the NOL Carry Back Period

There have been proposals to extend the period of time that companies can carry back their NOLs to offset income earned in prior years. Generally, NOLs can be carried back to offset income earned up to two tax years prior to the tax year the NOL is generated and may be carried forward for up to twenty years. Under the American Recovery and Reinvestment Tax Act of 2009,[6] the carry back period was extended to five years for NOLs generated in 2008 or 2009 by certain small businesses with less than $15 million of gross receipts.

Under WHBA, all eligible taxpayers may elect to increase the carry back period for an applicable NOL from two years to up to five years. The amount of an NOL that may be carried back to the fifth taxable year preceding the loss year is limited to 50 percent of taxable income for such taxable year. An applicable NOL is the taxpayer's NOL for a taxable year beginning or ending in either 2008 or 2009, but not both. In addition, the law allows the carry back of losses to fully offset alternative minimum taxable income (AMTI) arising during the extended carry back period. Under otherwise applicable law, NOLs can only be carried back to offset up to 90 percent of AMTI.

The increased carry back election is not available to any company that received, or that was a member of a consolidated group that had a member that received, any funding under the U.S. Treasury Department's Troubled Asset Relief Program (TARP).

C. Cap and Trade Legislation

On June 26, 2009, the U.S. House of Representatives passed the American Clean Energy and Security Act of 2009, HR 2454 (ACES), by a narrow margin of 219 to 212 votes. The legislation, which next moves into the Senate for consideration, purports to wean American industry from its carbon dioxide emission-based economy by gradually increasing the cost of carbon dioxide emissions. The proposed legislation has drawn criticism and questions from economists, environmentalist, and tax lawyers, among others.

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6. Div. B of ARRA, Pub. L. No. 111–5 (Feb. 17, 2009).

The ACES legislation starts from the proposition that carbon dioxide emissions are an unaccounted for environmental cost that our current economy ignores. The legislation would gradually increase the recognition of that cost and encourage reallocation of our energy sources using a mixture of governmental and market incentives. The proposed legislation first establishes a gradual reduction in the carbon dioxide emissions for the country as a whole. Such emissions would be reduced from their 2005 levels by the following amounts: (1) 3 percent in 2012; (2) 17 percent in 2020; (3) 42 percent in 2030; and (4) 83 percent in 2050. The legislation would effect these changes by requiring all industrial emitters of carbon dioxide to produce carbon dioxide within the limits of their emission allowances, acquire allowances from others, or pay a penalty. These emissions allowances would initially be allocated to existing producers as well as to certain green technology prompters. Some 80 percent of the allowances would be freely allocated, a percentage that would gradually decrease. The ACES legislation contemplates the development of a trading market so that emitters requiring allowances could trade for excess allowances allocated to others. The penalty payable if an emitter emits carbon dioxide unprotected by allowance is calculated at double the current trading price on the market. Thus, the penalty will create a strong economic incentive to obtain allowances.

Economists claim that the cap and trade idea, like the carbon taxes currently proposed in some of our trading partner countries, is designed to address a what is called a negative externality, i.e., the cost of environmental pollution unrecognized by our existing market economy. Countries such France are imposing a direct carbon tax to reflect such cost. The cap and trade alternative is designed to inject market recognition of this cost gradually into the system so that market based incentives will gradually encourage less polluting energy sources. One economist, Thomas Crocker, credited with being one of the original proposers of cap and trade, sees two fundamental problems with the approach. First, the pollution problem is global not local; and second, the difficulties in quantifying the environmental cost make the market based responsive to the problem hard to rationalize.[7]

The tax uncertainties and the political fallout of a disguised tax cost are as complicated as the economic and environmental issues associated with the legislation. Tax lawyers generally expect that the cost free allocation of emission allowances will follow the approach taken by the IRS in its sulphur dioxide emission allowances some years ago and not be taxable income to the recipients. Proceeds from a subsequent sale of allowances without any tax basis would then produce taxable income to the selling entity and recoverable tax basis to the purchasing entity. More troubling is the policy debate concerning whether the economic cost of carbon dioxide restraint and the cost of purchased allowances will increase the retail cost of electric power and all goods and services in the economy. Some commentators view this as a disguised tax burdening the population in a regressive way

7. Jon Hilsendrath, *Cap-and-Trade's Unlikely Critics: Its Creators*, WALL ST. J., Aug. 12. 2009, at 7.

because, like a broad based sales tax, the increase in the cost of electrical power falls disproportionately on low and middle income persons having to spend a larger portion of their income on electric power and necessary goods and services. The administration had suggested that the proceeds from the portion of emission allowances awarded through a governmental auction could be utilized to fund an earned income credit or other working and middle class targeted refundable credit designed to offset such costs.

D. Guidance on Renewable Energy Projects

1. Procedures for Election of Investment Tax Credit In Lieu of Production Tax Credit

President Obama signed the $787 billion economic stimulus package (ARRA) in January 2009, hoping to create jobs and spur private sector investment in clean energy. Tax incentives available under ARRA include tax credits and the highly anticipated section 1603 grants. ARRA also permits renewable energy project investors placing qualified facilities in service prior to 2013 (or before 2012 for wind facilities) to elect to receive a one-time investment tax credit (ITC) under IRS section 48 in lieu of the production tax credit (PTC) available under section 45. The ITC is generally equal to 30 percent of a renewable energy project's cost.

On June 5, 2009, the IRS issued Notice 2009–52, which describes the procedures investors must follow to make an election to take the ITC in lieu of the PTC. Notice 2009–52 provides that a taxpayer must make the election on a Form 3468, and a separate election must be made for each qualified facility (within the meaning of section 45) that is to be treated as a qualified ITC facility. The notice provides that taxpayers must attach a statement to the Form 3468 that includes the name, address, taxpayer identification number, and telephone number of the taxpayer. For each qualified investment credit facility, the attachment must include: (1) a detailed technical description of the facility, including generating capacity; (2) a detailed technical description of the energy property placed in service during the taxable year as an integral part of the facility, including a statement that the property is an integral part of such facility; (3) the date that the energy property was placed in service; (4) an accounting of the taxpayer's basis in the energy property; (5) a depreciation schedule reflecting the taxpayer's remaining basis in the energy property after the energy credit is claimed; (6) a statement that the taxpayer has not and will not claim a Section 1603 grant for property for which the taxpayer is claiming the energy credit; and (7) a declaration, applicable to the statement and any accompanying documents, signed by the taxpayer, or signed by a person currently authorized to bind the taxpayer in such matters, that the person signing has under penalties of perjury, examined the statement, including accompanying documents, and that to the best of his or her knowledge and belief, the facts presented in support of the statement are true, correct, and complete. The Form 3468 must be filed with the taxpayer's timely income tax return for the year in which the property is placed in service.

2. Guidance on Applying for Cash Grants in Lieu of Tax Credits

a. Overview

AARA Section 1603 provides direct cash payments to qualified applicants that place in service renewable energy facilities within a designated time period. In the past, tax credits have been widely used to create incentives for investment in renewable energy projects. Financial institutions provided a significant source of tax equity funding for these projects through the purchase of PTCs and ITCs.

In the current economic climate, the tax credit market has lost some of its momentum. The grant program aims to stimulate renewable energy projects by offering a more immediate stimulus in the form of a direct cash payment. This may be favorable for businesses seeking faster reimbursement of expenses rather than the delayed benefit of a tax credit. Those qualified to receive payments will forego the tax credits available under IRS Sections 45 or 48. Successful applicants will receive grants that equal 30 percent or 10 percent of the property's cost basis, depending on the type of property. The U.S. Treasury and U.S. Department of Energy estimate that at least $3 billion in financial support will be distributed to approximately 5,000 renewable energy production facilities under the program.

To claim a grant in lieu of the ITC or PTC, the taxpayer must place the renewable energy projects into service in 2009 or 2010, or after 2010 (as long as construction begins in either 2009 or 2010 and is completed prior to 2013 for wind facilities, 2017 for solar facilities, or 2014 for other energy technologies). Examples of property that may qualify for a grant include closed-loop and open-loop biomass property, fuel cell property, hydropower properly, combined heat and power system property, small and large wind property, marine hydrokinetic property, solar property, and microturbine property.

On July 31, 2009, the Treasury and DOE announced that they had started accepting applications for renewable energy projects seeking grant payments in lieu of tax credits. In addition to the online application, the Treasury has posted guidance, terms and conditions, and a sample application form.

b. Eligibility

The following entities are *not* eligible to participate in the grant program:

1. Federal, state, or local government or any political subdivision, agency, or instrumentality thereof, 501(c) organizations exempt from tax under section 501(a), and section 54(j)(4) entities.
2. Partnerships or pass-through entities with any government, section 501(c), or section 54(j)(4) entity as a direct or indirect partner, unless such entity owns only an indirect interest in the applicant through a taxable C corporation.
3. Foreign entities that do not qualify for the exception under section 168(h)(2)(B). Applicants must be the owners or lessees of the property and must have originally placed the property in service. The property must be used predominantly inside the United States.

c. Timeline

All applications must be received by Treasury before the statutory deadline of October 1, 2011. However, they may be submitted only after the property to which the application pertains is either placed in service or under construction. Construction is deemed to have commenced once physical work of a significant nature begins. A safe harbor provides that construction begins when the applicant incurs more than 5 percent of the total cost of the property.

Treasury will review and make payment to a qualified applicant within sixty days of receiving a completed application.

d. Tax Treatment

The grant payment generally is not included in the recipient taxpayer's gross income. Those receiving grants are required to reduce their basis in the property by an amount equal to 50 percent of the cash payment. The grant will be subject to recapture in the event the property is subject to a disqualifying event, such as sale of the property to a disqualified entity or a voluntary removal of the property from service.

e. Revisions to Cash Grant Guidance

On March 15, 2010, Treasury revised its 2009 guidance on the cash grant program (2009 Guidance) to clarify the meaning of when construction has begun (Revised Guidance). Of particular importance, the Revised Guidance expands the application of a safe harbor used to determine when construction has begun, perhaps though not entirely clear, allowing more projects to qualify for the safe harbor. Other than changes regarding the meaning of beginning of construction, the 2009 Guidance has not been revised.

f. Beginning of Construction

In order for property placed in service after 2010 to qualify for the cash grant, construction of the property must begin during 2009 or 2010. Construction begins when physical work of a significant nature begins. Work performed by the applicant and by other persons under a written binding contract is taken into account in determining whether construction has begun. There are two ways to show that construction has begun: (1) actual physical work of a significant nature; and (2) satisfaction of the safe harbor by paying or incurring more than 5 percent of the total cost of the property.

g. Physical Work of a Significant Nature

i. Generally

Both onsite and offsite work may be taken into account for purposes of demonstrating that physical work of a significant nature has begun. For example, in the case of a facility for the production of electricity from a wind turbine, onsite physical work of a significant nature begins with the beginning of excavating for the foundation, setting anchor bolts into the ground, or pouring the concrete pads

of the foundation. If the facility's wind turbines and tower units are to be assembled onsite from components manufactured offsite and delivered to the site, physical work of a significant nature begins when the manufacture of the components begins at the offsite location. If a manufacturer produces components for multiple facilities, reasonable methods must be used to link individual components with particular facilities.

Physical work of a significant nature does not include preliminary activities such as planning or designing, securing financing, exploring, researching, clearing a site, test drilling of a geothermal deposit, test drilling to determine soil condition, or excavating to change the contour of the land (as distinguished from excavating for footings and foundations).

ii. Self-Construction

If an applicant manufactures, constructs, or produces property for use by the applicant in the applicant's trade or business (or for the applicant's production of income), the work performed by the applicant is taken into account in determining when physical work of a significant nature begins.

iii. Construction by Contract

For property that is manufactured, constructed, or produced for the applicant by another person under a written binding contract that is entered into prior to the manufacture, construction, or production of the property for use by the applicant in the applicant's trade or business (or for the applicant's production of income), the work performed under the contract is taken into account in determining when physical work of a significant nature begins. The 2009 Guidance provides rules to determine if a contract is binding, and the Revised Guidance does not change these rules, other than to clarify that minor modifications to the property's design specifications, such as cold weather packages for wind turbines, do not affect the binding nature of the contract.

h. Safe Harbor

i. Generally

Under the 2009 Guidance, an applicant may satisfy the safe harbor when the applicant incurs (in the case of an accrual basis applicant) or pays (in the case of a cash basis applicant) more than 5 percent of the total cost of the property. For purposes of determining whether an accrual basis applicant has incurred more than 5 percent of the total cost of the property, the economic performance standards of IRS section 461(h) apply. Under those standards, economic performance generally occurs as services or property is provided rather than when payment is made.

Under the Revised Guidance, an applicant may treat physical work of a significant nature as beginning when more than 5 percent of the total cost of the property has been paid or incurred. Alternatively, the applicant may treat physical work of a significant nature as not having begun until more than 5 percent of the total cost of the property has been paid or incurred. The Revised Guidance no longer

provides that the economic performance standards of section 461(h) apply for purposes of determining whether an accrual basis applicant has incurred more than 5 percent of the total cost of the property. Thus, under the Revised Guidance, the safe harbor may be satisfied by paying or incurring 5 percent of the total costs, regardless of the applicant's accounting method.

In addition, under the 2009 Guidance, when property is manufactured, constructed, or produced for the applicant by another person, the 5 percent threshold must be met by the applicant and not the other person. In contrast, the Revised Guidance provides two sets of rules on when costs of the property are treated as paid or incurred based on whether the property is constructed by the applicant or by another person. When the property is constructed by another person, certain costs of that person are now taken into account.

ii. Self-Construction

In the case of property constructed by the applicant, costs of the property are treated as paid or incurred when paid or incurred by the applicant.

iii. Construction by Contract

In the case of property manufactured, constructed, or produced for the applicant by another person under a binding written contract that is entered into prior to the manufacture, construction, or production of the property, the cost of the property under the contract is treated as paid or incurred when the property is provided to the applicant, and for periods before the property is provided to the applicant, when paid or incurred by such other person. If the property includes both self-constructed components and components constructed under a contract, the costs relating to both are combined in determining if 5 percent of the total costs has been exceeded. Significantly, this new test requires developers of renewable energy projects to work with manufacturers of components with respect to the grant application. To meet the safe harbor threshold, developers may need to request invoices and other documentation from manufacturers to substantiate the project costs.

i. Additional Clarifications in the Revised Guidance

All costs included in the eligible basis of the specified energy property and only such costs are taken into account in determining if 5 percent of total costs has been exceeded. If the applicant is a lessee of property for which the lessor has elected to pass-through the credit to the lessee, this safe harbor must be met by the lessor unless the applicant sold and leased back the property.

j. Reliance on Prior Guidance

An applicant may choose to determine when construction begins under the 2009 Guidance or the Revised Guidance. However, since the satisfaction of the construction rules in 2010 is critical for projects intending to obtain the grant, the revised and modified safe harbor and construction rules discussed above likely should be used.

E. Federal Cases, Regulations, and Rulings

1. *Textron* Decision Regarding Tax Accrual Workpapers

On August 13, 2009, a divided First Circuit ruled that Textron Inc.'s tax accrual workpapers were "independently required by statutory and audit requirements and that the work product privilege does not apply."[8]

Textron's tax accrual workpapers included spreadsheets containing lists of items on Textron's tax returns that may be challenged by the IRS; estimates by Textron's counsel expressing, in percentage terms, their judgments regarding Textron's chances of prevailing in any litigation over these issues; and the dollar amounts reserved to reflect the possibility that Textron might not prevail in such litigation. Textron argued, among other things, that the tax accrual workpapers sought by the IRS were protected by the work product doctrine because they were prepared in anticipation of litigation.

In August 2007, the federal district court Rhode Island agreed with Textron that workpapers at issue were protected work product. In January 2009, a panel of the First Circuit affirmed. In a split decision, the panel agreed that one of the purposes behind the creation of the tax accrual workpapers was the anticipation of litigation, i.e., "the need to estimate the likelihood of success in litigation was a result of the need to set up a reserve fund to cover tax positions for which Textron could foresee disputes with the Service." Moreover, the panel rejected the government's argument that "the mere presence of a business or regulatory purpose defeats work product protection" on the grounds that "dual purpose documents created because of the prospect of litigation are protected even though they were also prepared for a business purpose."

Subsequently, the First Circuit granted the government's petition for rehearing en banc, vacating the panel's decision. The First Circuit issued its decision on August 13, 2009. In a three to two decision, the First Circuit reversed the district court's decision and held that "the Textron workpapers were independently required by statutory and audit requirements and that the work product privilege does not apply." Although the First Circuit couched its decision under the majority "because of" previously adopted by the court, the court rearticulated the standard as whether the documents were "prepared for use in possible litigation." The court noted that the trial judge had not made a "for use" finding. If he had, "that finding would have been clearly erroneous."

A dissent authored by Judge Juan R. Torruella accused the majority of abandoning the majority "because of" test in favor of the "prepared for" test, which is "an even narrower variant of the widely rejected 'primary motivating purpose' test used in the Fifth Circuit and specifically repudiated" by the First Circuit. In the dissent's view, the en banc court's decision is not only contrary to the precedent

8. *United States v. Textron Inc. et al.*, 577 F.3d 21 (1st Cir. 2009) (*en banc*); *cert.denied*, 2010 WL 2025148 (U.S. May 24, 2010).

of the First Circuit, but also creates a conflict with the Second Circuit decision in *United States v. Adlman*.[9]

The dissent also accuses the majority of stretching to reach a result oriented decision: "In straining to craft a rule favorable to the Service as a matter of tax law, the majority has thrown the law of work-product protection into disarray." The majority has succeeded to "further the split [among the circuits] by purporting to apply the 'because of' test while rejecting the test's protection for dual purpose documents." In fact, the majority has applied a new test that "requires that documents be actually 'prepared for' use in litigation." The dissent sends an invitation for resolution: "The time is ripe for the Supreme Court to intervene and set the circuits straight on this issue which is essential to the daily practice of litigators across the country."

2. Perspectives on Considerations to Protect Privilege with Respect to Tax Related Materials

There has been much interest in the First Circuit's controversial three-to-two decision. As discussed above, the majority in *Textron* effectively created a new and troubling standard for protecting documents under the work product doctrine. *Textron* left many unanswered questions, including: (1) Can backup memoranda be considered work product even if the accompanying spreadsheets are not?; and (2) If the subject documents are shared with an outside auditor, is work product protection waived under a theory that the auditor could be a conduit to a potential adversary, i.e., a taxing authority?

In addition to these issues, both the commissioner and the chief counsel of the IRS are attempting to modify the general relationship that the IRS has with large taxpayers to emphasize tax risk management and transparency.[10] Since the U.S. Supreme Court's decision in *United States v. Arthur Young & Co.*,[11] the IRS generally has adhered to a "policy of restraint" with respect to tax accrual workpapers.[12] In 2002, the policy was revised to allow the IRS it to request tax accrual workpapers related to "listed transactions."[13] It should be noted that this self-imposed policy was never intended by the IRS to concede that tax accrual workpapers were somehow protected under the attorney-client or statutory tax practitioner privilege. In fact, case law has fairly consistently held that tax accrual

9. 134 F.3d 1194 (2d Cir. 2002).

10. *See, e.g.*, John Klotsche, Neil Traubenberg & Tracy Hollingsworth, *Tax Risk Management: Shulman's Conversation with the Board*, TAX NOTES TODAY, Jan. 11, 2010. Transparency also has been emphasized by other governmental bodies. For example, in August 2007, the Senate Permanent Subcommittee on Investigations issued questionnaires to several large international corporations seeking background information with respect to their Financial Accounting Standards Board Interpretation No. 48 (FIN 48) reserves.

11. 465 U.S. 805 (1984).

12. IRS Announcement 84-46, 1984-18 IRB 18. Historically, the policy of restraint provided that an examiner would only request tax accrual workpapers in "unusual circumstances." IRM 4.10.20.3.1.

13. IRS Announcement 2002–63, 2002–2 C.B. 72. *See also* IRM 4.10.20.2; IRS A.M. 2007-12; LMSB-04-0507-044.

workpapers, once shared with an outside auditor, lose any potential for attorney-client or tax practitioner privilege.[14]

Most recently, the IRS issued Announcement 2010-9,[15] which effectively paves the way for the IRS to receive a road map that identifies uncertain tax positions of certain large corporate and partnership taxpayers. Announcement 2010-9 generally states that the IRS is developing a schedule that will require large business taxpayers to report uncertain tax positions on their tax returns. While the precise content has not been finalized, the schedule will require: (1) a concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statements; and (2) the maximum amount of potential federal tax liability attributable to each uncertain tax position (determined without regard to the taxpayer's risk analysis regarding its likelihood of prevailing on the merits). In addition to uncertain tax positions required to be reported under FIN 48, the IRS would also require the reporting of any position related to the determination of any federal income tax liability for which the taxpayer or related entity has not recorded a tax reserve because: (1) the taxpayer expects to litigate the position; or (2) the taxpayer has determined that the IRS has a general administrative practice not to examine the position.[16]

The First Circuit's decision, as well as Announcement 2010-9 and additional forthcoming IRS commentary, should cause tax professionals to review their processes and procedures with respect to confidential documents. One of the key components will be defining the line between collaboration with the IRS and protecting privileged material, as well as ensuring that tax risk management policies are adhered to in a consistent and uniform manner.

The issue of privilege protection is particularly relevant with respect to tax related documents.[17] For example, these documents could provide a roadmap of the technical issues and the taxpayer's legal analysis of the strengths and weaknesses of such technical issues.[18] In addition, such documents likely reveal the taxpayer's

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14. *See, e.g.*, United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982); *see also* Claudine V. Pease-Wigenter, *The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of U.S. v. Textron*," 8 Hous. Bus. & Tax L.J. 388 (2008).

15. 2010-7 IRB.

16. The IRS notes in the announcement that it intends to retain its existing policy of restraint for requesting tax accrual workpapers; however, the announcement cautions that the IRS will continue to review the policy and consider additional modifications, as appropriate or necessary, to ensure it obtains on a timely basis complete and accurate information regarding a taxpayer's uncertain tax positions.

17. For these purposes, tax documents include tax related memoranda, opinions, and emails, as well as various tax reporting financial data, which generally are referred to as tax accrual workpapers. The IRS has said that tax accrual workpapers include FIN 48 related materials that are prepared to comply with standards regarding accounting for uncertain tax positions. *See* A.M. 2007-0012 (3/22/07). Note that the IRS also has stated that FIN 48 disclosures "should be *considered* by examiners and others when conducting risk assessments." *See* LMSB-04-0507-044, May 10, 2007 (emphasis added).

18. The examining agent in *Textron* effectively acknowledged the "roadmap" notion in his testimony at the *Textron* evidentiary hearing. *See* transcript of *Textron* evidentiary hearing, beginning at page 90, C.A. No. 06–198T (June 26, 2007); *see also* Lee A. Sheppard, *News Analysis: Textron Case Expands Work Product Privilege*, Tax Notes Today, Sept. 11, 2007.

reserve for each item, as well as facts that the taxing authority may not otherwise discover. Furthermore, these documents may present facts and issues in a less favorable light due to the nature of their preparation.

It remains to be determined how the IRS's schedule, to be developed pursuant to Announcement 2010-9, will impact the foregoing concerns.[19] However, a well-defined policy that takes into account as many of the following considerations as practicable under the circumstances should place a taxpayer in the best possible position to defend against privilege challenges with respect to its tax accrual workpapers.[20]

a. Determine the Scope of Your Outside Independent Auditor's Review of Potentially Privileged Documents

It is likely that you will share some potentially privileged tax materials with your independent auditor in order for the auditor to attest to your tax reserves. However, attempting to limit the scope of the auditor's review could prove invaluable to protecting applicable privileges. Once a document has been shared with your auditor, the attorney-client privilege (as well as the tax practitioner privilege) generally is waived, although the document may continue to qualify for work product protection, as applicable.[21] Once the scope of your outside auditor's review has been defined, maintain meticulous records of what is shown to the auditor in order to preserve privilege protection for items that were not shared.

b. Implement Structured Criteria for Documenting Technical Conclusions and Maintaining and Sharing Technical Materials

In technical memoranda, opinions, and other communications, make appropriate references to the potential for litigation and the likelihood of success if challenged in court by the IRS or other taxing authority as relevant. For example, specifically discuss the potential litigation aspects of the issues, as well as the likelihood of success on the merits. As appropriate, clear legends on the face of documents (e.g., "Work Product Privileged and Confidential"; "Attorney-Client Privileged and Confidential"; if prepared by a nonattorney at the request of an attorney, "Prepared at the Request of Counsel") also should be used, although be

19. Note that Announcement 2010-9 does not purport to seek everything that typically is in a taxpayer's workpapers, including, for example, the odds of success or allocated reserves, which is the information that is the subject of *Textron*. In addition, IRS Chief Counsel William Wilkinson has stated that the new reporting obligation "does not directly change the IRS's policy of restraint with respect to tax accrual workpapers or make an end run around summons enforcement." *See* Jeremiah Coder, *Wilkins Discusses Need for Uncertain Tax Position Reporting*, TAX NOTES TODAY, Mar. 3, 2010.

20. It should be noted that no inference is intended that all of the considerations discussed in this report must be implemented in order to successfully defend against privilege challenges.

21. *See* United States v. Deloitte & Touche USA, LLP, 623 F. Supp.2d 39 (D.D.C. 2009); Regions Fin. Corp. v. U.S., 101 A.F.T.R.2d 2008-2179 (N.D. Ala. 2008), *appeal dismissed*, No. 08-13866 (11th Cir. 2008); *see also* Simon v. G.D. Searle & Co., 816 F.2d 397 (8th Cir. 1987), *cert. denied*, 484 U.S. 917 (1987).

mindful of overusing legends—use them only when appropriate given the nature and content of the communication.

In addition, technical memoranda, opinions, and other communication should be maintained separately from corresponding nontechnical documents. Strictly limit access (both paper and electronic) to intended privileged materials and include only members of the privilege group (i.e., those who "need to know") in distribution lists or access approvals. The privilege group members should be easily identifiable and known. For example, indicate who the privilege group members are directly on paper and electronic file labels and working group lists. Ideally, separate file systems should be maintained for technical memoranda and communications and the privileged files should be kept under the dominion and control of the privilege group.

c. Clearly Define the Role of Attorneys

To the extent practicable, use lawyers to create work product related materials. While it is well established that "work product" need not be attorney work product, provided that it is prepared in anticipation of litigation, it generally is easier to illustrate that a document is work product when an attorney, or a person working for the attorney, prepares it.[22]

Separate legal advice from nonlegal advice (e.g., tax return preparation, financial accounting) by using appropriate terminology in requesting and rendering legal advice. Similarly, separate transactional legal advice from potential controversy legal advice. For example, to the extent practical, separately engage transactional counsel for transactional matters and litigation counsel for potential controversy matters. It should be noted that if engaging separate counsel is not practical, protection may still be available provided that the document was in fact prepared in anticipation of litigation as well as for a transactional or business purpose.[23]

Litigation counsel should be consulted with respect to the determination of whether litigation may be anticipated for a given issue. Place litigation holds on all documents (paper and electronic) related to an issue for which work product privilege protection may be claimed. In order to avoid spoliation issues, adhere to your internal document retention and destruction policy, if applicable. Generally, such policy should explain the purposes underlying it (e.g., the justification for such destruction) and be followed consistently (i.e., selective application may raise suspicions).

d. Cooperate with the IRS and Other Taxing Authorities by Furnishing all Nonprivileged Information and Documentation in a Timely Manner

Requests for documents generally could come through a routine audit or upon receiving a summons. Regardless of the genesis of the request, all nonprivileged materials should be provided in a timely manner. In addition to fostering good

22. *See, e.g.*, United States v. Davis, 636 F.2d 1028 (5th Cir. 1981), *cert. denied*, 454 U.S. 862 (1981); United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982).

23. *See, e.g.*, United States v. Roxworthy, 457 F.3d 590 (6th Cir. 2006).

will, this tactic could discourage additional requests for potentially privileged documents. Note that submitting documents to taxing authorities pursuant to a request should not constitute subject matter waiver. For example, pursuant to recently revised Federal Rule of Evidence 502, waiver of the attorney-client privilege or work product privilege with respect to undisclosed information concerning the same subject matter could occur if a party intentionally discloses protected information in a selective, misleading, and unfair manner. This represents a narrowing of the scope of potential subject matter waivers and, as acknowledged by the IRS, should protect undisclosed documents as a result of disclosing requested documents in the context of a tax audit or summons.[24]

e. Establish Well-Documented Processes and Procedures for Tax-Related Materials

In addition to defining the scope of an auditor's review of potentially privileged materials, work with tax and litigation counsel to develop documented policies and procedures with respect to tax-related materials. In the event of litigation with respect to privilege, a formal policy should significantly enhance the chances of being successful because clear distinctions between protected and unprotected documents and consistent practices are vital.

3. Change in Tax Accounting Method for Repair and Maintenance Costs

For tax purposes, most investor-owned utilities historically have capitalized all of the costs incurred with respect to tangible personal property, although the utilities would have been permitted to deduct some of those costs currently under the tax law. In many cases, this tax accounting method was attributable to the utilities conforming their tax treatment of the expenditures to their regulatory treatment of the expenditures. Important to the determination of whether a particular expenditure is capitalized or deducted as a repair is the taxpayer's definition of a unit of property. In general, a taxpayer must capitalize costs to replace or improve a unit of property but may deduct costs to maintain the property in its normal operating condition. If one taxpayer defines its units of property as larger items than another taxpayer, the first taxpayer generally would be permitted to currently deduct more significant expenditures than the second taxpayer would be permitted to deduct. This is so because similar expenditures with respect to the larger unit of property are less likely to add value to that unit of property, prolong its life, or adapt it to a different use. In contrast, an expenditure with respect to the smaller unit of property is more likely to be a replacement of the item, add value, or prolong its useful life.[25] For example, if one electric utility defines a turbine as a unit of property and

24. *See, e.g.*, Office of Chief Counsel Notice 2009-023, CC-2009-023 (Aug. 3, 2009). Note that some courts have held that subject matter waiver can only occur with respect to the attorney-client privilege and not to work product protection. *See, e.g.*, Periman v. United States, 665 F.2d 1214 (D.C. Cir. 1981); *In re* Sealed Case, 676 F.2d 793 (D.C. Cir. 1982).

25. *See* Treas. Reg. § 1.263(a)-1.

another defines each turbine blade as a separate unit of property, the replacement of a turbine blade by the first utility is a deductible repair that is necessary to keep the turbine in its normal operating condition, but the replacement of the turbine blade by the second is the replacement of a unit of property, and therefore a capital expenditure.

Approval from the IRS is necessary for a taxpayer to change its tax method of accounting. Over the last year, many taxpayers have requested the permission of the IRS to change their methods of tax accounting for costs to repair tangible personal property and their related designations of units of property. The IRS has acted favorably on a number of these requests subject to a determination by field examiners that the new methods of tax accounting are appropriate. Resolution of the ultimate methods of tax accounting may take a substantial period of time, because the issues are highly factual in nature and vary significantly by taxpayer, although the IRS is expected to attempt to define common rules for taxpayers within particular industries. Due to the volume of requests received and the decision to approve these changes subject to field examination, the IRS has announced procedures pursuant to which the consent to the method of tax accounting change is deemed to be granted automatically but is still subject to field examination.[26]

4. IRS Issues Revenue Procedure Regarding Tax Treatment of Smart Grid Grants

a. Smart Grid Grants

On October 27, 2009, President Obama announced $3.4 billion in DOE grants under ARRA intended to support modernization of the energy grid within the United States (smart grid grants). The DOE awarded the smart grid grants to approximately one hundred recipients. According to a DOE press release, these grants were projected to result in an aggregate investment by the DOE and smart grid grant recipients in excess of $8 billion.

As taxpayers went through the application and selection process, many practitioners focused increasingly on the proper tax treatment of the smart grid grants. On March 10, 2010, after recipients had been identified and had begun negotiating the smart grid grant award agreements with the DOE, the IRS issued Revenue Procedure 2010-20, which provides a safe harbor for smart grid grants. Under the Revenue Procedure, smart grid grants to corporations will be treated as nontaxable nonshareholder contributions under Section 118(a), as amended.

b. Statutory Background

Section 118(a) provides that a corporation is not required to include a contribution to the corporation's capital in gross income. Treasury Regulation Section 1.118-1 provides that the exclusion under the section applies to contributions to the corporation's capital made by nonshareholders. The regulations cite as

26. Rev. Proc. 2009-38, 2009-38 I.R.B. (Aug. 27, 2009).

examples payments from a governmental unit to induce a corporation to locate its business in a particular community and payments made to enable a corporation to expand its operating facilities.

Section 362(c)(2) provides that a corporation receiving cash that qualifies under Section 118(a) must reduce the corporation's tax basis of any property acquired with such cash by the amount of the cash contribution.

c. Revenue Procedure 2010-20

Revenue Procedure 2010-20 provides that the IRS will not challenge a corporation's treatment of a smart grid grant as a nontaxable nonshareholder contribution to the capital of the corporation, provided that the corporation properly reduces its tax basis in the corresponding property in accordance with Section 362(c)(2). The Revenue Procedure applies to corporate taxpayers that receive smart grid grants under 42 U.S.C.§ 17386 (federal matching fund for smart grid investment costs) from DOE. The Revenue Procedure does not apply to noncorporate taxpayers or to grants under 42 U.S.C.§ 17384 (smart grid technology research, development, and demonstration grants).

d. Impact on Recipients

Revenue Procedure 2010-20 should simplify the smart grid grant recipients' implementation of their projects by clarifying the proper tax treatment of the grants. Although numerous nontax issues exist, Revenue Procedure 2010-20 should simplify the negotiation process for some recipients and the DOE. This guidance also should simplify the ratemaking process and other dealings between the recipients and state regulatory agencies.