

XIV. Taxation and Accounting

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The committee gratefully acknowledges the contributions of David R. Hardy, a partner in the New York City office of Osler, Hoskin & Harcourt LLP; Charles A. Mannix, Cleco Corporation in Pineville, Louisiana; Russell J. Kestenbaum, a partner, and Drew Batkin, an associate, in the New York City office of Milbank, Tweed, Hadley & McCloy; Philip Tingle, a partner, and Caroline Hong Ngo, an associate, in the Washington, D.C., office of McDermott Will & Emery; Benjamin I. Delancy and Daniel L. Hogans, both partners, and Vicki M. Nielsen, an associate, in the Washington, D.C., office of Morgan, Lewis & Bockius LLP; and Gerald P. Towne a manager in the Washington, D.C., office of PricewaterhouseCoopers. Messrs. Hardy, Kestenbaum, Mannix, and Tingle are vice chairs of the Taxation and Accounting Committee.

A. INTRODUCTION

This report reviews significant tax and accounting developments relevant to the Section of Public Utility, Communications and Transportation Law, including certain tax and benefit provisions of the American Recovery and Reinvestment Act of 2009 (Stimulus Act). President Obama signed the \$787 billion economic stimulus package, which contains \$293.7 billion in tax incentives, on February 17, 2009. Among other items, the report also reviews the U.S. Treasury regulations on tax return preparer penalties, proposed regulations on nuclear decommissioning, and guidance on nonqualified deemed compensation plans. In addition, this report covers several traditional utility issues, including customer connection fees and the normalization rules, and the *Textron Inc. v. United States* decision regarding tax accrual workpapers. Finally, this report describes a study regarding the impact that a change in dividend tax rates may have on utility shareholders.

B. FEDERAL LEGISLATION

1. American Recovery and Reinvestment Act of 2009 (Stimulus Act)

a. Renewable Energy Provisions

The tax provisions of the Stimulus Act provide for \$20 billion of investment in renewable energy, including a three-year extension of the production tax credit (PTC); the option to take the PTC as an investment tax credit (ITC), which can be used immediately rather than taken into account over several years; and the option to receive a cash grant rather than use the applicable ITC. A summary of the important tax provisions relating to renewable energy follows.

The Act extends for three years the period during which qualified facilities must be placed in service in order to receive the PTC under section 45 of the Code.¹ PTCs may be available for wind facilities if they are placed in service on or before December 31, 2012, and for other qualified facilities, such as closed-loop biomass, open-loop biomass, geothermal, small irrigation, hydropower, landfill gas, waste-to-energy, and marine renewable facilities, if they are placed in service on or before December 31, 2013.

An important new provision under section 48 of the Code allows a wind facility placed in service in 2009 through 2012, or other qualified facility placed in service between 2009 and 2013, to elect to receive an ITC in lieu of a PTC. As a result, any qualifying facility that is placed in service within the specified time frame would be entitled to a 30 percent ITC on the date it was placed in service. The benefit of receiving an ITC in lieu of a PTC is that a qualified facility would be entitled to the tax credit immediately, instead of having to take the tax credit into account over the ten-year production period that would typically be required under section 45.

1. All section references in this part of the report are to the Internal Revenue Code of 1986, as amended).

Section 1603 of the Stimulus Act supplements this election with a provision that permits certain qualified facilities to apply for a cash grant in lieu of the applicable ITC. Taxpayers may receive a grant with respect to eligible property placed in service in 2009, 2010, or after 2010 so long as construction begins in either 2009 or 2010 and is completed prior to 2013 (wind facility), 2017 (solar facility), or 2014 (other energy technologies). In most cases (e.g., wind and solar facilities), the grant would equal 30 percent of the total cost of the facility placed in service. Moreover, the grant will operate similar to the ITC in that it will not be taxable upon receipt and will reduce the tax basis of the facility by 50 percent of the amount of such grant. The Treasury Secretary will pay the grant within sixty days of the date of the application for such grant or the date that the property is placed in service, whichever comes later.

The Act also repeals the ITC's subsidized energy financing limitation. This provision permits projects to be financed by subsidized energy financing and still be entitled to the full 30 percent ITC. Finally, the Stimulus Act authorizes the issuance of up to \$1.6 billion in additional new clean renewable energy bonds and \$2.4 billion in additional qualified energy conservation bonds.

b. Bonus Depreciation

The Stimulus Act also extends for one year the availability of bonus depreciation for qualified property placed in service by the taxpayer before January 1, 2010. Section 168(k) permits a taxpayer to deduct 50 percent of the cost of qualified property, in addition to regular tax depreciation, in the year the property is placed in service. The Act changes the progress expenditure rule to provide that property with a long production period qualifies for the placed-in-service deadline to the extent of adjusted basis attributable to manufacture, construction, or production after December 31, 2007, and before January 1, 2010. The Stimulus Act satisfies the timely acquisition requirement if the property is acquired by the taxpayer either: (1) after December 31, 2007, and before January 1, 2010, but only if no binding contract for the acquisition was in effect before January 1, 2008; or (2) under a binding written contract entered into after December 31, 2007, and before January 1, 2010. Taxpayers that are manufacturing, constructing, or producing property for their own use must begin the manufacture construction or production before January 1, 2010, to meet the timely acquisition requirement.

c. Cancellation of Debt Income Deferral

The Stimulus Act includes a provision allowing companies to defer tax on certain cancellation of debt income (CODI) in connection with a repurchase or restructuring of existing debt. It also includes related tax accounting provisions.

i. Background

An issuer recognizes CODI with respect to a debt instrument (existing debt) when: (1) the issuer or a related party purchases the existing debt for an amount less than its "adjusted issue price," including purchases where the consideration is new debt, stock and/or other property; or (2) the existing debt instrument is

modified in a manner significant enough to constitute a deemed exchange of the existing debt for new debt for tax purposes. CODI can also arise when an equity owner contributes debt to the capital of the issuer.

Generally, an issuer recognizes CODI to the extent that the adjusted issue price of the existing debt is greater than the cash, the issue price of the new debt, and/or fair market value of other property it or a related party delivers (or in the case of a deemed exchange, is deemed to deliver) in exchange for the existing debt. Where debt is contributed to a corporation by a shareholder, CODI equals the excess of the adjusted issue price of the contributed debt over the shareholder's tax basis in that debt. The adjusted issue price of existing debt is generally the amount paid by the initial purchaser increased by any accrued original issue discount and decreased by any payments other than qualified stated interest payments (i.e., stated interest that is required to be paid at least annually). The issue price of new debt issued (or deemed issued) in exchange for existing debt is generally the fair market value of the new debt if the new debt or existing debt is treated as traded on an established market within the meaning of the tax law, or the face amount of the new debt if neither the new debt nor the existing debt is so traded and the new debt provides for adequate stated interest.

Prior to enactment of the Stimulus Act, a taxpayer that was neither in bankruptcy nor insolvent at the time it recognized CODI would be required to include CODI in taxable income for the year when the events giving rise to the CODI occurred. A taxpayer that is in bankruptcy or insolvent at the time it recognizes CODI can exclude the CODI from taxable income (in the case of an insolvent taxpayer, only up to the amount of the taxpayer's insolvency) but must reduce certain tax attributes (including net operating loss carry-forwards, general business credit carry-forwards, and tax basis in assets) by the amount of the CODI that is excluded from income.

ii. Changes Under the Stimulus Act

The Stimulus Act generally allows a taxpayer that recognizes CODI in 2009 or 2010 to elect to defer including the CODI in taxable income. The election to defer CODI is made separately for each debt issuance, allowing a taxpayer to make the election for some but not all issuances. CODI deferred pursuant to this election must be included in the gross income of the taxpayer ratably over the five taxable years beginning with the fifth taxable year following the taxable year in which the CODI arises if the CODI event occurs in 2009, or the fourth taxable year following the taxable year in which the CODI arises if the CODI event occurs in 2010. Any deferred CODI that has not been taken into income is included in taxable income at the time the taxpayer ceases operating, liquidates, or sells all of its assets. A taxpayer that elects to apply the Stimulus Act's deferral rules to a particular debt issue cannot make use of the bankruptcy or insolvency exception with respect to that debt issue.

Example 1: On April 1, 2009, X, a calendar year taxpayer purchases for \$60 cash its own existing debt with an adjusted issue price of \$100. The \$40 difference between the cancelled debt's adjusted issue price (\$100) and the cash purchase

price is CODI for *X*. If *X* elects under the Stimulus Act to defer the \$40 of CODI, *X* will include the CODI in taxable income \$8 per year for each year from 2014 through 2018.

Example 2: Assume the same facts as Example 1, except that instead of purchasing its debt for cash, *X* issues a new note with a \$75 stated principal amount and 10 percent interest payable annually in cash, in full satisfaction of its \$100 of existing debt. Further assume that the \$100 of existing debt is traded on an established market within the meaning of the tax law and it has a fair market value of \$60. *X* recognizes the same \$40 of CODI which it can elect to defer until 2014 and then include in income ratably from 2014 through 2018.

In a debt-for-debt exchange (including a deemed exchange resulting from a modification of existing debt), if the stated redemption price at maturity of the new debt is greater than its issue price, the difference will be treated as original issue discount (OID). The issuer would normally deduct the OID over the life of the debt on a yield to maturity basis. However, the Stimulus Act provides that an issuer electing to defer CODI on retired debt must also defer deductions of OID on new debt issued for the retired debt up to the amount of the deferred CODI. This deferred OID is deductible over the same five-year period during which the deferred CODI is included in income.

Example 3: Assume the same facts as under Example 2 above. The \$15 difference between the new debt's \$75 stated redemption price at maturity and its \$60 issue price is OID. If *X* elects under the Stimulus Act to defer including CODI in income, *X* will also have to defer deductions attributable to the OID for periods from the April 1, 2009, issuance through December 31, 2013. The issuer will then deduct 20 percent of the OID in each year from 2014 through 2018.

The Stimulus Act also suspends the "applicable high yield discount obligation" (AHYDO) rules in certain situations. As a general rule, the issuer of a debt instrument treated as an AHYDO cannot deduct OID attributable to yield in excess of certain thresholds, and remaining OID cannot be deducted until paid. Generally, a debt instrument issued by a corporation is treated as an AHYDO if it has a term exceeding five years, significant original issue discount (as defined in the Code), and a yield that equals or exceeds the applicable federal rate plus 5 percent. The Stimulus Act provides that the AHYDO rules will not apply to new debt issued in exchange for existing debt of the same issuer if: (1) the existing debt is not an AHYDO; (2) the new debt is treated as issued after August 31, 2008 and prior to January 1, 2010; and (3) the new debt is not issued to a person related to the issuer within the meaning of the tax law. The Stimulus Act also authorizes the Treasury Department to extend this suspension of the AHYDO rules to instruments issued after 2009, to use a rate that is higher than the applicable rate when determining whether a debt instrument is to be treated as an applicable high yield discount obligation, or both.

iii. Effect of the Stimulus Act

The CODI deferral rules greatly facilitate the repurchase or refinancing of outstanding debt that is trading at a significant discount. Although the deferral does not eliminate taxation of CODI, it provides a lengthy period for taxpayers to pay

the associated taxes. For amendments to debt that cause a deemed exchange, the new rules will effectively eliminate the tax on the CODI other than for instruments with a remaining maturity in excess of ten years. There may also be situations where taxpayers eligible for the bankruptcy or insolvency exceptions to the recognition of CODI are better off electing to defer including CODI in income in lieu of reducing its tax attributes. For example, an insolvent or bankrupt taxpayer with projected taxable income that can be offset by tax attributes that must otherwise be reduced by excluding CODI may benefit from electing instead to defer including CODI, thereby preserving the benefit of its tax attributes.

d. Extended Net Operating Loss Carry-back Period

Prior to enactment of the Stimulus Act, a taxpayer could generally carry back its net operating losses (NOLs) to offset taxable income generated in the two taxable years preceding the year in which the NOL arose. In an effort to stimulate the economy during the recession that occurred earlier this decade, the Job Creation and Worker Assistance Act of 2002 (Jobs Act) extended the NOL carry-back period to five years for NOLs generated in 2001 and 2002. Following the lead of the Jobs Act, early drafts of both the U.S. House and Senate bills that served as the basis for the Stimulus Act included a provision extending the carry-back period for NOLs generated in 2008 and 2009 to five years. Both the House and Senate bills favored an extended five-year NOL carry-back for all 2008 and 2009 NOLs, but in an effort to manage the overall size of the Stimulus Act, the NOL carry-back provision in the enacted legislation was much more limited.

The provision included in the Stimulus Act allows small businesses to elect to carry back 2008 and 2009 NOLs for up to five years. For purposes of the extended carry-back provision, a business will be treated as a small business only if its average gross receipts for the three years ending with the year in which the NOL arises is no greater than \$15 million. As a result, the extended NOL carry-back provision is of limited application.

Following passage of the Stimulus Act, business organizations have been urging Congress to extend the five year NOL carry-back rule to all companies that generate NOLs in 2008 and 2009. Members of Congress have also supported legislation that would give all taxpayers the benefit of an extended NOL carry-back period. In addition, the president's February 2009 proposed budget blueprint includes a line item to "expand net operating loss carry-back." On April 2, 2009, U.S. Senate Finance Committee Chairman Max Baucus (D-MT) and Senator Olympia Snowe (R-ME) introduced a bill that would allow all businesses to carry back losses from 2008 and 2009 for up to five years. The proposed legislation would not apply to companies that received funds from the Troubled Asset Relief Program (TARP).

2. U.S.-Canadian Tax Treaty Protocol Enters Into Force

On December 15, 2008, Canada and the United States announced that the September 21, 2007, protocol (Protocol) to the Canada-United States Income Tax Convention (Treaty) had entered into force.

Among the more notable changes, the Protocol eliminates withholding tax on arm's length interest payments and guarantee fees sourced from one country to eligible residents of the other Treaty country. Under the previous version of the Treaty, interest payments not otherwise eligible for exemption under domestic law were subject to source country withholding tax at a rate of up to 10 percent. The 10 percent withholding tax rate as it applies to interest payments to related parties is not eliminated immediately but will be phased out over three years. The benefit of the reduced withholding rates will not be available for certain types of participating interest (e.g., where interest is determined based on receipts, sales, income, profits, or other cash flows of the debtor or a related person). Participating interest will be subject to a 15 percent rate of withholding under the amended Treaty.

The Protocol allows eligible U.S. residents to claim Treaty protection for Canadian source income derived through U.S. limited liability companies. However, it appears that the Protocol will adversely affect withholding tax treatment of payments made to or through certain other hybrid entities that are characterized inconsistently for U.S. and Canadian purposes (e.g., Nova Scotia unlimited liability companies that are corporations for Canadian tax purposes but pass-through entities for U.S. tax purposes). Lastly, the Protocol provides for binding arbitration of unresolved cases involving double taxation.

Generally, the changes made by the Protocol will be effective for tax years beginning in 2009. The changes relating to withholding tax on cross-border payments (other than interest) generally apply as of February 1, 2009. The Protocol changes with respect to withholding tax on most cross-border payments of interest (including the first phase reduction of interest payments to related persons) are retroactively effective to January 1, 2008. The application of rules relating to the denial of Treaty benefits for certain hybrid entities and the implementation of the new "services permanent establishment rule" provision are delayed until January 1, 2010.

C. FEDERAL REGULATIONS, RULINGS, AND CASES

1. Statutory and Regulatory Modifications to Return Preparer Penalties

In May 2007, the Code was amended to toughen section 6694 regarding the imposition of penalties on tax return preparers filing income tax returns with positions having a dim likelihood of success. As previously reported, these return preparer penalties are important because they may be imposed upon lawyers advising on the treatment of an item representing a substantial portion of a tax return. The tax return preparers also may have a higher threshold of probability for avoiding penalties than those actually imposed upon the taxpayer, thereby creating an inherent conflict of interest. Finally, the tax return preparer penalties have affected the relationship between tax lawyers and accounting firms that frequently prepare the taxpayers' actual returns. Important modifications of these rules emerged in 2008.

Raising the penalty threshold for return preparers grew out of the higher standards imposed upon KPMG in its deferred prosecution agreement for promoting and facilitating tax shelters. However, the amendment of section 6694 was

sufficiently controversial that the IRS suspended enforcement of the new provision until 2008 so that rules could be drafted to explain its operation.² In general, the new section imposed a penalty on a tax return preparer who filed a tax return containing an understatement of tax liability due to a position that the preparer knew (or reasonably should have known) was not based upon a reasonable belief that the position would more likely than not be sustained on the merits. Lower levels of probability can avoid penalties if the position is disclosed to the IRS. The imposition of these penalties upon tax lawyer advisors occurs because preparer is defined to mean a person “who prepares for compensation all or a substantial portion of a return.” The penalty is \$1,000 per occurrence, or 50 percent of the income derived by the preparer.

As originally proposed, the rules triggered several difficult issues, including: (1) The difference in penalty thresholds for return preparers and for the taxpayers themselves created conflicts of interest; (2) Certain rules for avoiding penalties could jeopardize the confidentiality of attorney-client communication; and (3) The new rules tended to make the tax return preparer accounting firm the arbiter of the correctness of transactional legal advice.

Congress amended these controversial penalty rules in the Emergency Economic Stabilization Act of 2008.³ Most important, the Act eliminated the potential conflict between the taxpayer and tax return preparer by harmonizing the penalty thresholds for each. Section 6694, as amended in 2008, provides that an undisclosed position that is not a “tax shelter” or “reportable transaction” will not subject the preparer to penalties if the position is supported by substantial authority. Other non-tax shelter positions will not incur penalty if they are adequately disclosed and supported by a reasonable basis position. Tax shelter positions are subject to other disclosure rules but may be included on a return if the preparer reasonably believes the position is more likely than not correct.

In 2008, final regulations under section 6694⁴ were also released interpreting the tax return preparer penalties. They clarified many of the proposed provisions, including the determination of the primary preparer in a firm with multiple preparers and the determination of the income base upon which the penalties are to be asserted. Revenue Procedure 2009-11 was released in early 2009 to provide guidance on the types of returns and claims that would be subject to the penalties.

Finally, Notice 2009-5, 2009-3 I.R.B. 309 was released to define “substantial authority” for purposes of section 6694 penalties. That notice incorporates prior definitions utilized in section 6662 and the regulations thereunder. The notice incorporates the standard that substantial authority requires support from some written determination, such as federal court cases, IRS rulings, or other determinations, but does not include treatises, periodicals, and legal opinions other than the authorities on which such opinions rely. The notice also clarifies that for positions, other than positions regarding tax shelters and reportable transactions,

2. Notice 2007-54, 2007-27 IRB 12.

3. P.L. 110-343 (Oct. 3, 2008).

4. T.D. 9436 (Dec. 15, 2008).

the notice is effective for all advice and returns prepared after May 25, 2007, the date of the original change to the tax return preparer penalties.

2. Proposed, Temporary, and Final Regulations Under Section 468A Relating to Deductions for Contributions to Qualified Funds

The IRS and the U.S. Department of the Treasury have issued proposed, temporary, and final regulations under section 468A relating to deductions for contributions to qualified nuclear decommissioning trust funds.⁵ The temporary regulations became effective on December 31, 2007, and apply with respect to taxable years ending on or after that date.

a. Removal of the Cost of Service Requirement

Under prior law, deductible contributions to qualified funds were limited to the lesser of the amount of decommissioning costs included in a utility's cost of service for ratemaking purposes or the ruling amount. The temporary regulations have removed the cost of service requirement for contributions to a qualified fund. However, taxpayers that are regulated by a public utility commission (PUC) must submit the information and assumptions used by the PUC in determining decommissioning costs included in cost of service in their requests for schedules of ruling amounts. Taxpayers may use alternative assumptions in the computation of the ruling amount but must demonstrate that the proposed schedule of ruling amounts is consistent with the principles and provisions of the temporary regulations and is based on reasonable assumptions.

b. "Special Transfers" (or Pourovers) of Previously Nonqualifying Decommissioning Costs

The temporary regulations provide that a taxpayer maintaining a qualified fund may make a special transfer of cash or property (e.g., stocks and bonds) into the fund equal to the present value of the "pre-2005 nonqualifying amount" of nuclear decommissioning costs for the related plant.

No gain or loss is recognized on any special transfer. The taxpayer's basis in the qualified fund is not increased by reason of the special transfer and the qualified fund's basis in the property is the same as the transferor's basis in the property immediately before the transfer. Before making a special transfer, the taxpayer must request a "schedule of deduction amounts" from the IRS on or before the deemed payment deadline for the taxable year of the transfer.

c. Pre-2005 Nonqualifying Decommissioning Costs

The maximum special transfer is equal to the present value of future decommissioning costs that were ineligible for contribution to the qualified fund under section 468A as in effect under prior law. For these purposes, the pre-2005 nonqualifying amount means the portion of decommissioning costs equal to 100 percent minus the qualifying percentage for the plant and minus the percent-

5. Temp. Reg. 1.468A-1T through 1.468A-8T.

age of decommissioning costs transferred in any previous special transfer. This calculation does not take into account the balance in the existing qualified fund.

d. Deductions for Special Transfers

In general, the deduction for a special transfer is allowed ratably over the remaining estimated useful life of the plant. This is the period that begins with the year of the special transfer and ends with the year that the plant will no longer be included in the taxpayer's rate base as determined in the first ratemaking proceeding involving the plant.

Because the temporary regulations use the initial ratemaking proceeding as the reference period or use information available at the time a plant was placed in service, the period of years over which the deductions for a special transfer can be claimed often will be shorter than other reference periods, such as current rate-making projections or current operating license terms.

The deduction for property contributed in a special transfer is limited to the lesser of the fair market value of the property contributed or the taxpayer's basis in the property. Where a taxpayer contributes appreciated property to a qualified fund as part of the special transfer, the taxpayer's deduction is limited to the adjusted basis of such property, although the amount of the special transfer looks to the fair market value of the appreciated property.

3. 2008 Guidance with Respect to Section 409A Violations: Income Inclusion and Corrections

In December 2008, the Treasury and the IRS issued long-awaited guidance on failures of nonqualified deferred compensation plans to comply with section 409A. The three items of guidance discussed in this section include:

- (1) Proposed regulations on how to calculate the amounts to be included in income in the event of a section 409A violation, and the additional taxes imposed by section 409A on employees participating in noncompliant deferred compensation plans;⁶
- (2) Interim guidance to employers on their reporting and wage withholding requirements with respect to amounts includible in income under section 409A⁷; and
- (3) Procedures under which taxpayers may obtain relief from the full application of the income inclusion and additional taxes under section 409A with respect to certain operational failures to comply with section 409A.⁸

a. Proposed Regulations on Income Inclusion

If a nonqualified deferred compensation plan fails to comply with section 409A in form or in operation, all amounts deferred pursuant to that plan (and all plans

6. 73 Fed. Reg. 74,380.

7. Notice 2008-115, 2008-52 IRB 1367.

8. Notice 2008-113, 2008-51 IRB 1305.

aggregated with that plan) are immediately includible in income unless they were previously included in income or are subject to a substantial risk of forfeiture (i.e., are not vested). The income tax on the amount includible in income is increased by 20 percent plus an additional amount equal to interest on the underpayments, using the interest rate on underpayments plus one percentage point. This is determined by assuming that the deferred compensation should have been included in gross income for the year of deferral or the year during which the deferred compensation vested, whichever falls later. State tax penalties may also be applicable.

The proposed regulations contain detailed rules for each step of the calculation and for applying that calculation to each type of arrangement subject to section 409A. Although they contain several helpful provisions, the proposed regulations will also create additional administrative burdens and complexity, the most significant of which are discussed below.

End of the year rule. The amount includible in income would be the present value of all amounts payable calculated as of the last day of the taxable year during which the violation occurred, regardless of the date of noncompliance. If a violation occurs early in a year (e.g., in January), amounts deferred later during that same year would also be includible in income even if there were no section 409A violations with respect to those later deferrals.

Effect of distributions during the year. Amounts distributed during the year of noncompliance would be includible without regard to: (1) whether the distribution was in compliance with section 409A; or (2) whether the distribution occurred before or after the violation. As a result, a violation late in a year (e.g., in December) would result in additional taxes on amounts distributed at any time during the year.

Short term deferrals. On the last day of a taxable year, certain payments may qualify as short term deferrals if paid on or before the end of the relevant two-and-one-half-month period. Any payments that qualify as short term deferrals would not be included in the section 409A includible amount. If those amounts are subsequently not paid within the short term deferral period, they would be included in the section 409A includible amount for the year during which the short term deferral period expired (typically, the next calendar year).

Effect of notional investment losses. Notional investment losses that occur during a taxable year (as well as actuarial and other similar reductions) will reduce the present value of the amount payable under a plan determined as of the end of the year and, therefore, are effectively netted against any gains that occur during the same taxable year because of notional investment gains, additional deferrals, or other additions to the amount payable under the plan. As with the other provisions, this rule would apply to all notional losses during the year regardless of whether a deemed loss occurs before or after the date of any violation.

Deduction for certain includible amounts. The proposed regulations provide a deduction to service providers to the extent that the amount paid to the service provider is less than the amount previously included in income as a result of a violation of section 409A if those amounts are later forfeited or permanently lost,

provided that the service provider does not retain a right to any amount deferred under the plan. This deduction would be available if the employer was insolvent or bankrupt at the time payment was due as well as for reductions in the amount paid due to deemed investment losses.

Significant differences with section 3121(v). If the proposed regulations become final, employers would likely have to create and implement new procedures for tracking and calculating the section 409A includible amounts. Section 409A calculations differ significantly from the calculation required by section 3121(v) for purposes of determining Federal Insurance Contributions Act (FICA) taxes on deferred amounts.

One important difference is the treatment of earnings. For purposes of section 409A, earnings on previously deferred amounts are also treated as deferred compensation subject to section 409A. Accordingly, the proposed regulations would require any earnings when reporting or taxing deferred amounts to be included in income. In contrast, once FICA tax has been paid on deferred amounts in accordance with section 3121(v), subsequent earnings are generally not treated as additional deferrals.

Another key difference is the proposed treatment of certain conditions on the future payment of deferred amounts. For purposes of section 409A, the proposed regulations would require using reasonable assumptions regarding the probability that any conditions would be satisfied and the use of other assumptions relating to the time, form, and amount of payment.

b. Effective Date

The proposed regulations will be effective once they are finalized. In the interim, reliance on the proposed regulations constitutes compliance with Notice 2008-115.

c. Notice 2008-115: Reporting and Withholding Guidance

Notice 2008-115 generally extends the reporting and withholding guidance provided in Notice 2006-100 and Notice 2007-89 applicable to 2005, 2006, and 2007. However, the notice provides that compliance with the proposed regulations will also constitute compliance with the notice. The notice is effective for 2008 and is expected to remain in effect for subsequent years until the proposed regulations are finalized and effective.

d. Notice 2008-113: Section 409A Correction Opportunities

A number of tools are available for addressing section 409A compliance failures that can limit and, in some cases, eliminate the adverse tax consequences of an inadvertent failure to follow the rules under section 409A. In Notice 2008-113, the IRS provided lengthy and detailed guidance for operational failures that are fixed within certain limited periods following the occurrence of the failure. It is important to note, however, that Notice 2008-113 generally does not offer relief for a failure to satisfy the documentary requirements of section 409A. In addition, as discussed below, a special opportunity for correction during 2009 is provided, but the window of opportunity is limited to 2009.

e. Correcting Section 409A Operational Failures

Notice 2008-113 offers correction opportunities that vary based on whether the affected individual is an insider or not. For this purpose, an insider is determined under the section 16 rules of the Securities Exchange Act, applied without regard to whether the company's securities are registered. Accordingly, nonpublic companies are also treated as having insiders for purposes of these rules.

The availability and method of correction also vary based on how soon the error is fixed (e.g., same year, next year, or by the end of the second following year). The method of correction required is specified based on the nature of the error, such as delayed payment, inadvertent payment in an earlier year, or inadvertent early payment in the same year, or payment in violation of the six-month delay requirement for specified employees.

Finally, there is a special rule for corrections involving amounts not greater than the limit on elective deferrals under section 402(g) (\$16,500 for 2009). An operational failure may be fixable under more than one category of correction, and attention should be given to the most administratively and otherwise attractive alternative for correction.

The rules for correction under Notice 2008-113 are detailed and, in some cases, administratively complex. They may require repayment of early distribution amounts and interest charges in some instances. The recordkeeping involved for such corrections represents a challenging task with respect to plans administered by outside vendors or on a large scale. Prompt attention to early detection and correction of mistakes is encouraged.

In general, corrections of errors in the same year, or with respect to non-insiders, are treated with greater leniency than later corrections or those of insiders. For example, errors can generally be corrected in the same year without incurring the otherwise applicable additional taxes under section 409A. For non-insiders, it is possible to correct in the next following year without additional section 409A taxes. For insiders and non-insiders, corrections of violations involving limited amounts (up to the section 402(g) limit) and corrections made by the end of the second year following the year of the error require a payment of the 20 percent additional tax only. This avoids the additional interest tax and application of the section 409A aggregation rules, which, if applicable, would require application of the 20 percent tax to all plans of the same "kind."

Relief under Notice 2008-113 is available only if reasonable steps are taken to prevent recurrence. In all cases, disclosure to the IRS and affected plan participants is required, either in the form of a prescribed statement or in the form of reporting under Code Z on an applicable W-2 or Form 1099. On a more troubling note, correction relief is not available for inadvertent early payments in cases where the payer is facing substantial financial downturn. Given the current economic environment, concerns have been expressed to the IRS regarding the application of this rule and its impact on the availability of correction relief.

f. Special 2009 Opportunity for Correcting Failures for Non-Insiders

Under a potentially valuable transition rule in Notice 2008-113, there is an opportunity to correct any specified operational failure occurring prior to 2009 with

respect to a non-insider without incurring section 409A additional taxes. This provision allows for identification and correction of such failures in 2009, going back to the effective date of section 409A on January 1, 2005. This opportunity will expire at the end of 2009.

4. Revenue Ruling 2008-30—Change in Method of Accounting for Customer Connection Fees

The IRS recently addressed the issue of whether a public utility's change in the manner in which it accounts for customer connection fees constitutes a change in accounting method requiring the IRS's consent. Revenue Ruling 2008-30 describes a regulated public utility that charges new customers a fee to offset the cost of extending existing sewer lines to its premises. For several years, the utility treated the sewer connection fees as contributions in aid of construction (CIACs), which are excluded from gross income under section 118. Because the utility did not include the fees as income, it did not claim any tax basis in the sewer lines and did not claim depreciation deductions. The utility later determined that the sewer connection fees did not qualify as CIAC, after which it began including the fees in income and depreciating the sewer lines.

Under similar facts to those described in Revenue Ruling 2008-30, two different courts held that a taxpayer's change in the treatment of connection fees did not constitute a change in accounting method that required IRS consent.⁹ Nevertheless, in Revenue Ruling 2008-30, the IRS held that a change from treating customer connection fees as CIAC that excluded from income under section 118 to taxable income constitutes a change in method of accounting and does require consent. The IRS noted that it does not acquiesce with the holdings in *Saline Sewer* and *Florida Progress*. The IRS noted that a change that affects the proper time for including income or deductions is indeed a change in the accounting. The IRS then reasoned that the current income and offsetting depreciation deductions available over a period of time associated with including the fees in income resulted in a change in the proper time for including income or deductions as compared to an exclusion from income and no deductions as was reported when the fees were treated as CIACs.

5. Non-Shareholder Contributions to Capital

In Private Letter Ruling 200820033, the IRS ruled that payments by a city to a utility to place its overhead utility lines and related equipment underground in a historic district serviced by the utility are non-taxable, non-shareholder contributions to the capital of the corporation under section 118.

Section 118 provides that contributions to a corporation's capital are not included in its gross income. However, the section 118 exclusion does not apply

9. See *Saline Sewer Co. v. Comm'r, T.C.* Memo 1992-236 (1992); *Florida Progress Corp. v. United States*, 156 F. Supp. 2d 1265 (M.D. Fla. 1999), *aff'd per curiam on other issues*, 264 F.3d 1313 (11th Cir. 2001).

to a CIAC. A CIAC has generally been defined to include contributions by customers or other persons that are transferred to provide or encourage the provision of services to or for the benefit of the transferor.

This ruling underscores existing IRS guidance and evaluates existing case law differentiating contributions to capital from a CIAC. The IRS's position is that a payment is not a CIAC and therefore can be a non-taxable contribution to capital if it does not reasonably relate to the provision of services or to the benefit of the person making the payment, but rather relates to the benefit of the public at large. Specifically, a payment is not considered a CIAC where the service performed for the payment is undertaken for purposes of community aesthetics and public safety and does not directly benefit particular customers.

6. Normalization Rules and Application of Section 199 Domestic Production Activity Deduction Where Utility Uses Net Operating Loss Carryover

In Private Letter Ruling 200833014, the IRS ruled that the Code's normalization rules were not violated where a taxpayer's tax expense for ratemaking purposes was calculated by taking into account the domestic production activities deduction (DPAD) under section 199.

Taxpayers are generally permitted to claim accelerated depreciation deductions for federal income tax purposes. However, a taxpayer is not permitted to claim accelerated depreciation of public utility property unless the taxpayer uses a normalization method of accounting. A normalization method of accounting requires the taxpayer to compute its tax expense for ratemaking purposes by calculating depreciation using recovery periods and conventions established by the taxpayer's regulator.

In the ruling at issue, the taxpayer is the parent company of a regulated public utility. The taxpayer's group of affiliates is involved in the generation, transmission, and distribution of electricity. The regulatory commission with jurisdiction over the public utility sought to determine the utility's tax expense for purposes of setting appropriate rates. The utility did not pay any federal income tax in the test year used by the commission because of a net operating loss carryover. However, the regulatory commission's rules do not allow the commission to take into account any tax benefit associated with a net operating loss carryover in determining federal income tax expense for rate-making purposes.

The commission therefore determined the utility's federal tax expense by computing the its pro forma federal tax liability. In the computation, the regulatory commission determined the DPAD that the utility would have been able to claim on a stand-alone basis. The DPAD is a fixed percentage of a modified net income calculation that takes into account accelerated depreciation. By including the DPAD, the regulatory commission indirectly based rates on a calculation using accelerated depreciation. In an attempt to increase its tax expense for ratemaking purposes, which would increase the rate the utility could charge its customers, the taxpayer asked the IRS to rule that use of the DPAD in calculating tax expense for ratemaking purposes violates the normalization provisions.

The IRS noted that, while satisfaction of the normalization rules requires that there be an adjustment to tax expense as a result of application of accelerated depreciation for tax purposes, the normalization rules do not apply to other book tax timing differences nor do they apply to a permanent tax difference such as the DPAD. As a result, the regulatory commission's determination of regulatory tax expense by computing the DPAD based on a pro forma return claiming accelerated depreciation deductions did not violate the normalization rules of the Code.

7. Notional Principal Contracts Referencing Certain Real Estate Investments Are Not USRPI—Rev. Rul. 2008-31

On June 12, 2008, the IRS issued Revenue Ruling 2008-31, which holds that a notional principal contract the return on which is calculated by reference to the value of a broad range of real estate is not a United States real property interest (USRPI).

Generally, a person purchasing a USRPI from a foreign seller is required to withhold and pay to the Treasury 10 percent of the amount realized by the foreign seller. Section 897(c)(1) defines a USRPI as an "interest in real property" located in the United States or the Virgin Islands. The Code broadly defines "interest in real property" to include "fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon." Treasury regulations provide that an interest in real property also includes "any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property."¹⁰

Revenue Ruling 2008-31 describes a foreign person that enters into a notional principal contract within the meaning of Treasury regulations sections 1.446-3(c)(1) and 1.863-7(a) (NPC) with an unrelated counterparty. The returns are based on a widely published index that measures the appreciation and depreciation of certain real estate values within a defined statistical area within the United States that has a population of more than 1 million people during a defined testing period. The IRS concludes that the NPC is not a USRPI within the meaning of the Code, and the counterparty is not required to withhold 10 percent on payments made to the foreign person under the NPC. In reaching this conclusion, the IRS notes that "the NPC does not represent a 'direct or indirect right to share in the appreciation in the value . . . [of] the real property' within the meaning of Treas. Reg. § 1.897-1(d)(2)."

8. *Textron* Decision Regarding Tax Accrual Workpapers

In its January 2009 decision, *Textron Inc. v. United States*,¹¹ the First Circuit upheld a federal district court decision that concluded that tax accrual workpapers prepared by a taxpayer are protected by the work product doctrine. However, the

10. Treasury Reg. § 1.897-(d)(2)(i).

11. 103 AFTR 2d 2009-509, Jan. 21, 2009.

court held that waiver of the protection from the work product doctrine may occur if the taxpayer's analysis is reflected in the auditor's workpapers, which are not protected by the work product doctrine. The court remanded the case to the district court for further proceedings to determine whether the auditor's workpapers would reveal the information contained in Textron's own workpapers, and whether the auditor's workpapers are discoverable on the grounds that the taxpayer has the legal right or ability to obtain these documents.

Tax accrual workpapers provide support for a taxpayer's financial statement tax reserves, including such sensitive issues as the taxpayer's judgment about situations where the tax laws are unclear, or its likelihood of success in a dispute with the IRS. The IRS had a long history of restraint under which it would not seek tax accrual workpapers absent "unusual circumstances." The IRS has changed this policy, however, if the taxpayer claimed a tax benefit in certain instances from what are considered to be tax shelters.

The First Circuit upheld the district court's finding that one of the purposes behind the creation of the tax accrual workpapers was the anticipation of litigation: "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 IRS." The court considered the issue of whether Textron had waived work product protection by showing its tax accrual workpapers to its independent auditor, Ernst & Young (E&Y). Unlike the attorney client privilege, the work product privilege can be waived by disclosure of otherwise protected work product to a litigant's (real or potential) adversary. The First Circuit acknowledged that several courts have found no such waiver upon a taxpayer's disclosure of its tax accrual workpapers to its independent auditor.

The First Circuit acknowledged that the Textron workpapers may be discoverable. Whether Textron waived work-product protection by disclosing them to E&Y depends to what extent E&Y's workpapers evidence the contents of Textron's workpapers. Since the district court did not address this issue, the First Circuit remanded the case for an *in camera* inspection or to take testimony on the issue. On March 25, 2009, the government's petition for rehearing *en banc* was granted, and prior panel opinion and judgment were withdrawn and vacated, respectively. The *en banc* hearing was scheduled for June 2, 2009.¹²

D. OTHER

U.S. individual taxpayers are currently subject to federal income tax on dividends received from a U.S. corporation at a maximum 15 percent rate unless the individual is in the 10 percent or 15 percent tax brackets in which case the dividends are not subject to U.S. tax. The preferential tax rates on dividend income are

12. 103 AFTR 2d 2009-1436, Mar. 25, 2009.

scheduled to expire for dividends paid on or after January 1, 2011. Dividends paid by utilities generally represent a higher percentage of income for people in lower tax brackets as compared to dividends from companies in other industries. To determine the impact that a change in dividend tax rates in 2011 may have on utility shareholders, the Edison Electric Institute and the American Gas Association commissioned E&Y to determine the types of utility shareholders most impacted by the favorable dividend tax rates.

The E&Y study concluded that 64 percent of federal tax returns reporting dividend income from the direct ownership of utility shares were filed by persons sixty-five and older. The study also concluded that approximately 42 percent of federal tax returns reporting utility-related dividend income were filed by persons with incomes of less than \$25,000 and 68 percent of those returns were filed by persons with income of less than \$75,000. In 2008, the 15 percent tax bracket, and thus the zero percent rate on dividend income, applied to a married couple filing a joint return with taxable income of \$65,100 or less.