Textron Reversal Fuels Tax Accrual Workpaper Controversy

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The disclosure of tax accrual workpapers is an issue of debatable importance in the area of tax compliance and litigation. The IRS claims to seek them only on a limited basis, and the government seldom loses court cases involving listed transactions, with or without access to the workpapers. However, the strong push by the IRS to litigate the issue has consumed an awful lot of the Justice Department's and courts' attention over the last few years. The strange thing about the litany of decisions on the issue is that neither taxpayers nor the government seems to be clearly winning, and the courts seem divided on even the nature of tax accrual workpapers. The First Circuit's recent reversal of a panel decision in favor of the taxpayers in *Textron* is unlikely to put the issue into clearer focus.

Judge Michael Boudin, who dissented from the panel decision that held that workpapers are protected under the work product doctrine because they are prepared in anticipation of litigation, came out on top in the *en banc* rehearing, authoring a 3-2 majority opinion ruling that workpapers are tax documents and not case preparation materials. The majority opinion emphasized that it was a reaffirmation of *Maine*, a First Circuit opinion that adopted a ''because of'' test. The majority seemed to focus on the fact that the workpapers were created because of statutory and audit requirements and not for litigation. The dissent found the majority's claim of reaffirming *Maine* to be ''simply stunning'' because Judge Juan Torruella, who wrote the original panel opinion, believed that the majority was completely misinterpreting *Maine*'s because of test. The test, when applied properly, does not limit the privilege to documents prepared for use in litigation, according to Judge Torruella.

Members of the tax community will likely be split on the opinion. Most of the initial reaction by practitioners was negative or favored the dissent's reasoning, but others, especially academics such as Profs. Dennis Ventry and Steve Johnson, previously argued that a reversal was the right result. With the First, Second, and Fifth circuits all having different tests or opinions on the work product doctrine's applicability to tax accrual workpapers, the issue seems ripe for a Supreme Court review. Such a review, though, is unlikely, meaning that attorneys and tax professionals are likely to be influenced in their creation of workpapers by which circuit jurisdiction they live and practice in. (For coverage of the decision, see p. 638. For Ventry's primer, see *Tax Notes*, May 18, 2009, p. 875. For Johnson's analysis, see *Tax Notes*, July 13, 2009, p. 155.)

UBS Settlement

An agreement was reached early last week among the Swiss and U.S. governments and UBS AG on the John Doe summons case in a Florida district court. Although details of the agreement were not confirmed by any side, it is likely that UBS will release fewer than 10,000 of the more than 50,000 names sought by the Justice Department and that no monetary penalty will be paid by the bank. Those hoping that the UBS matter might deliver a deathblow to bank secrecy are likely to be disappointed. (For coverage of the UBS settlement, see p. 631.)

FBARs Revisited

Last week Lee Sheppard provided an analysis of how new FBAR rules would affect hedge fund managers and investors. This week Sheppard provides her perspective on FBARs and trust funds (p. 632). After an interesting social critique of the difference between the traditional wealthy and parvenus, Sheppard finds that FBAR rules are much less flexible for trust funds than hedge funds. She writes that in this case the newly wealthy hedge fund crowd received more favorable treatment than old money. Specifically, she looks at the expansive nature of the IRS requirement that all potential beneficiaries and those with even restricted powers of appointment must file an FBAR. Showing a bit of sympathy for beneficiaries who might have trouble obtaining account information from distrustful trustees, Sheppard writes that the IRS should consider redesigning the FBAR for trust funds and letting a trustee file one report for all potential beneficiaries.

Commentary

It is no secret that the United States is suffering from severe financial constraints, and the effect of the increasing debt-to-GDP ratio is not lost on policymakers or academics. The country will need revenue, and one possible source is the creation of the first value added tax in the United States. But is there any chance that lawmakers will ever seriously consider adopting a VAT? Sijbren Cnossen thinks that the United States will have to consider creating a VAT to pay for universal healthcare. In a special report, he provides a VAT primer for lawyers, economists, and accountants. Cnossen compares the VAT with other consumption taxes, concluding the VAT is the preferred choice because it is the most neutral and feasible. One major advantage, according to Cnossen, is that the VAT is not a cost to business. Of course, this means that the cost of the tax is borne by consumers, which explains, in large part, its regressivity. That regressivity is a major reason that a VAT faces an uphill battle in Congress. (For Cnossen's analysis, see p. 687. For coverage of the VAT debate, see p. 644.)

The U.S. government's path to fiscal unsustainability is also the focus of Gary Fleischman's viewpoint (p. 699). Fleischman believes that the growth in public debt must be controlled and reversed, especially in the medium and long term. The author argues that tax reform will be an important component in closing the budget deficit. Fleischman supports long-term binding budget resolutions, a reversal of distortionary tax expenditures, and the imposition of a flat tax rate. Although his advocacy of a flat tax rate as a solution to the government's budgetary crisis doesn't seem to address the need for additional revenue, Fleischman is correct that a reform of the nation's tax structure will be vital in the coming months as the Obama administration confronts the consequences of reckless spending. A flat tax isn't likely to be supported by David Cay Johnston. In Johnston's Take, he examines how the tax policies of the Reagan, both Bush, and Clinton administrations have contributed to widening gaps between high-, middle-, and low-income taxpayers (p. 713). According to Johnston's data, obtained from the IRS, households making more than $1 million a year captured 36.1 percent of the total real increase in incomes from 2006 to 2007, even though they accounted for only 1 out of 364 taxpayers.

The American Recovery and Reinvestment Act of 2009 is a major component of the United States' current and future inflated budget deficit. Although not a large component of the tax portion of that bill, the amendments to section 108 regarding the timing of the recognition of cancellation of indebtedness income related to business debt have received a great deal of attention from practitioners. Blake Rubin, Andrea Macintosh Whiteway, and Jon Finkelstein analyze the issues that arise in the application of section 108(i) to partners and partnerships. The authors conclude that Treasury guidance is needed on these issues as soon as possible, particularly on matters involving partnership debt allocations and debt instruments applicable to partnerships. Their special report starts on p. 677.

The Partnership Tax Report this week tackles CFC stock handled by foreign partnerships (p. 709). Monte Jackel and Robert Crnkovich write that this issue causes confusion galore and that guidance is needed on the application of sections 705, 959, and 961 which provide for the treatment of subpart F inclusions, previously taxed income distributions, and basis increases and decreases that take into account the hodgepodge created by section 958. Robert Willens returns this week to analyze section 351's "control immediately after" requirement for nonrecognition (p. 717). Specifically, Willens analyzes transactions designed to avoid qualifying under section 351 and how recognition is sometimes in a taxpayer's favor. In a viewpoint on p. 702, Alan Feld writes that Congress should allow the real property tax supplement to the basic standard deduction to expire as scheduled. Feld believes that "the provision adds little utility but does contribute to the complexity and incoherence of the tax code."

Robert Wood addresses the deductibility of stock offering lawsuit settlements in a practice article, concluding that many businesses have difficulty deciding which payments should be deducted and which should be capitalized. He concludes that the origin of the claim doctrine sounds more precise than it is. However, reaching a conclusion about a claim's origin is critical for securing deductibility (p. 671). Robin Westbrook provides an article on pro bono opportunities for tax lawyers (p. 704). Westbrook writes that lawyers have an ethical obligation to perform pro bono work and lists resources that can help a tax attorney who wishes to undertake such service. W. Joey Styron analyzes the *Valero* decision's effect on privileged communications, providing a detailed list of the implications of the Seventh Circuit opinion for tax professionals (p. 675). ■