

MEMORANDUM FOR LARGE AND MID-SIZE BUSINESS DIVISION EXECUTIVES,
MANAGERS AND EXAMINERS
SMALL BUSINESS/SELF EMPLOYED DIVISION EXECUTIVES,
MANAGERS AND EXAMINERS

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SUBJECT: Obtaining Tax Accrual Workpapers Related to Abusive Tax
Avoidance Transactions

This memorandum addresses administrative procedures to be used in connection with the Announcement changing the Service's policy concerning when it will request tax accrual and other financial audit workpapers relating to the tax reserve for deferred tax liabilities and to footnotes disclosing contingent tax liabilities appearing on audited financial statements. This action is another in a series of steps that the IRS and Treasury are taking to curb abusive tax avoidance transactions and to ensure that taxpayers comply with the tax law.

New Procedures for Examination of Returns Involving Listed Transactions

Announcement 2002-63 changes existing policy regarding when requests for tax accrual workpapers may be made. For returns filed after July 1, 2002, the Service will, in appropriate circumstances, request tax accrual workpapers whenever it determines that there was a tax benefit claimed on the return from any transaction that the Service has determined to be a listed transaction (or a transaction that is substantially similar to a listed transaction) at the time of the request within the meaning of Temp. Treas. Reg. § 1.6011-4T(b)(2). (Temp. Treas. Reg. § 1.6011-4T(b)(2) defines listed transactions to include substantially similar transactions.) Specifically, if the listed transaction was disclosed in accordance with Temp. Treas. Reg. § 1.6011-4T, the Service routinely will request the tax accrual workpapers pertaining only to the listed transaction. If the listed transaction was not disclosed, the Service routinely will request all tax accrual workpapers. In addition, if the Service determines that tax benefits from multiple investments in listed transactions are claimed on a return, regardless of whether the listed transactions were disclosed, the Service, as a discretionary matter, will request all tax accrual workpapers. Similarly, if, in connection with the examination of a return claiming tax benefits from a listed transaction that was disclosed, there are reported financial accounting irregularities, such as those requiring restatement of earnings, the Service, as a discretionary matter, will request all tax accrual workpapers.

For returns filed prior to July 1, 2002, the Service will, in appropriate circumstances, request tax accrual workpapers pertaining to a listed transaction whenever it determines that there was a tax benefit claimed on the return from the transaction that the Service

has determined was a listed transaction at the time of the request (within the meaning of Temp. Treas. Reg. § 1.6011-4T(b)(2)) and the taxpayer had an obligation to disclose the transaction under Temp. Treas. Reg. § 1.6011-4T and failed to do so (1) on the return; (2) under Rev. Proc. 94-69, 1994-2 C.B. 804, if applicable; or (3) pursuant to Announcement 2002-2, 2002-2 I.R.B. 304 (Jan. 14, 2002). The request, however, will be limited to the tax accrual workpapers pertaining only to the listed transaction.

This change in policy applies only to examinations of original returns. Where the tax return does not fall within the scope of the new policy, agents should continue to follow the Service's current procedures regarding requests for tax accrual workpapers as set out in Appendix I.

The examination team should work closely with its local counsel office to develop the precise language for the request. The request will be addressed to both the taxpayer and the independent auditor and should seek the tax accrual workpapers each may have in their possession or control relating to the tax reserves for deferred tax liabilities and to footnotes disclosing contingent tax liabilities appearing on the audited financial statements. If the request is being made in connection with the examination of a return claiming tax benefits from a disclosed listed transaction, the request will be limited to the tax accrual workpapers pertaining only to the listed transaction. All other requests relating to returns filed on or after July 1, 2002, that claim tax benefits from listed transactions, will be for all tax accrual workpapers.

If the taxpayer or the independent auditor fails to comply with the request in a timely fashion, the examination team, in coordination with local counsel, will attempt to resolve the matter administratively. Counsel will assist in responding to any claims of privilege.

Should the taxpayer or the independent auditor decline to produce all of the tax accrual workpapers requested that are within their possession or control, or fail to respond to the request, the Service will prepare a summons for the material. The summons should be directed to the person -- either the taxpayer or the independent auditor (or both) -- who has failed to produce the tax accrual workpapers. This summons will be approved, prior to issuance, by the Director of Field Operations, LMSB, or the Area Compliance Director, with the concurrence of the Director of Compliance Policy, SB/SE. Counsel's review of the summons will be coordinated through the appropriate Division Counsel and the Associate Chief Counsel (Procedure & Administration).

Should the taxpayer or the independent auditor (or both) fail to comply with the summons, the Service will refer the matter to Counsel for enforcement of the summons. After review by the responsible Division Counsel and coordination with Associate Chief Counsel (Procedure & Administration), the summons enforcement letter will be approved by Deputy Chief Counsel (Operations).

Use of Tax Accrual Workpapers

The tax accrual workpapers obtained under these procedures will be used in the examination of any listed transactions, or items related to listed transactions, whether or not disclosed on the return. Where the request covers all tax accrual workpapers, agents should use their best judgment and apply risk analysis in using information in the tax accrual workpapers unrelated to listed transactions as a basis for further examination of new and undeveloped issues.

These procedures will be added to the IRM in both the summons and examination parts at the earliest opportunity. Please send comments or questions to the following email address: otsa@irs.gov.

Appendix I

Current Procedures for Requesting Audit and Tax Accrual Workpapers

Under current procedures, tax reconciliation workpapers, unlike audit workpapers and tax accrual workpapers, are normally requested at the beginning of an examination. Tax reconciliation workpapers, which are also referred to as tax workpapers, are those workpapers used in assembling and compiling financial data preparatory to placing it on a tax return. Typically these papers will include final trial balances for each entity and a schedule of consolidating and adjusting entries. They include information used to trace financial information to the tax return.

Audit workpapers and tax accrual workpapers, however, should normally be requested only in unusual circumstances and when necessary factual data used to support the return cannot be obtained from the taxpayer's records. The term "audit workpapers" refers to workpapers retained by the independent auditor as to the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to its examination. Audit workpapers may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor. These workpapers provide important support for the independent auditor's opinion as to the fairness of the presentation of the financial statements, in conformity with generally accepted auditing standards. The term tax accrual workpapers refers to those audit workpapers -- whether they are created by the taxpayer or the independent auditor -- relating to the tax reserve for deferred tax liabilities and to footnotes disclosing contingent tax liabilities appearing on audited financial statements.

Because taxpayer's records are the primary source of factual data to support the tax return, audit or tax accrual workpapers prepared by the independent auditor should only be used if factual data cannot be obtained from the taxpayer's records. If requested, the tax accrual workpapers should only be used as a collateral source for factual data. See IRM 4.45.7.6.5:1;4.10.2.9.4(4). Examiners should use discretion in requesting tax accrual workpapers and should not request them as a matter of standard examining procedure.

Unusual circumstances supporting a request for tax accrual workpapers will exist when:

- the examiner has identified a specific issue or issues and needs additional facts regarding those issues,
- the examiner has obtained from the taxpayer all the facts the taxpayer has relating to the identified issues, and
- the examiner has asked the independent auditor to provide any supplementary analyses relating to the identified issues other than those that may be contained in the tax accrual workpapers.

For example, after the examiner has audited the taxpayer's records regarding the reserve for bad debts, the examiner may request the audit workpapers relating to the reserve for bad debts first from the taxpayer and then from the independent auditor if those workpapers are determined to be necessary.

Before requesting tax accrual workpapers from the independent auditor, the examiner should first take all reasonable means to secure this information from the taxpayer. This will require the examiner first to request this information from the taxpayer, and, if that is not successful, to summon a financial officer or the tax manager of the taxpayer, so that it can be determined whether they possess the information sought. In addition, the reconciliation of Schedule M-1 must be made before considering whether to request tax accrual workpapers. IRM 4024.4 (5-14-81).

If unusual circumstances exist, the examiner's request for tax accrual workpapers should be limited to the portion of the workpapers that are material and relevant to the examination. Whether an item is considered to be material is based on the examiner's judgment and an evaluation of the facts and circumstances in the case. In situations where it is deemed necessary to request tax accrual workpapers, the prior written approval of the Director of Field Operations, LMSB, or the Area Compliance Director, with the concurrence of the Director of Compliance Policy, SB/SE is required.

If it is necessary to issue a summons to secure audit or tax accrual workpapers, the examiner should ensure that the burden of compliance with the summons will not be unreasonably onerous. The summons should provide a specific and unambiguous description of the records demanded, so that the summoned party can reasonably identify the exact records sought. The summons should also identify the particular taxpayer for which the documents are sought, the period covered, and the nature of the documents. Unless the examiner determines that all the workpapers are material and relevant, the summons should identify and request only those documents relating to the specific matters under consideration. Finally, the summons should specify whether it seeks audit or tax accrual workpapers.

Prior to issuance, a summons for audit or tax accrual workpapers will be submitted to Field Counsel for review and comment, accompanied by a statement of the applicable facts and circumstances. Local Counsel must coordinate review of the proposed summons and any summons enforcement letters through the appropriate Division Counsel with the Associate Chief Counsel (Procedure & Administration). See CCDM 34.12.3.