

LARGE & MIDSIZE BUSINESS DIVISION
OFFICE OF TAX SHELTER ANALYSIS
Announcement 2002-63 -Tax Accrual Workpapers
Frequently Asked Questions
8-28-2002

- Q1. Why has the Service changed its policy regarding requests for tax accrual workpapers?
- A. Although the Service has long had broad authority to request tax accrual workpapers, it has historically declined to use such authority as a standard examination technique. Due to the recent growth in abusive corporate tax avoidance transactions, the Service is refining its policy regarding requests for tax accrual workpapers in a way that will promote compliance and ensure that all taxpayers pay the proper amount of tax. The new policy is intended to change taxpayer behavior by raising the stakes of investing in aggressive transactions.
- Q2. For what years may an examiner request the tax accrual workpapers?
- A. The new policy generally applies to returns filed on or after July 1, 2002. In certain cases, the new policy applies to returns filed before July 1, 2002.
- Q3. Why do different procedures apply to returns filed before July 1, 2002, and those filed on or after that date?
- A. The July 1, 2002, cut-off date provides taxpayers filing on an extended due date an opportunity to reconsider a shelter transaction before reporting it on their 2001 return. It also allows them enough time to adjust their filings. The change was intended generally to be prospective, with retroactive effect only for taxpayers who have failed to meet the existing requirements for disclosing abusive tax avoidance transactions.
- Q4. In what situations will the IRS request tax accrual workpapers for returns filed on or after July 1, 2002? Will it request all workpapers?
- A. For returns filed on or after July 1, 2002, that claim a tax benefit from a listed transaction, the following procedures will apply:
- (a) If the transaction was disclosed in accordance with Temp. Treas. Reg. §1.6011-4T, the Service will routinely request the workpapers pertaining only to the listed transaction.
- (b) If the transaction was not disclosed in accordance with Temp. Treas. Reg. 1.6011-4T, the Service will routinely request all tax accrual workpapers.

- (c) If tax benefits from multiple investments in listed transactions are claimed on a tax return, regardless of whether the transactions were disclosed, the Service, as a discretionary matter, will request all tax accrual workpapers. In general, the presumption should be to request all tax accrual workpapers in these situations. See Q&A 8, for more information about the discretion that should be exercised.
- (d) If, benefits from a listed transaction are claimed on a tax return that was disclosed, but there are reported financial accounting irregularities, such as those requiring a restatement of earnings, the Service, as a discretionary matter, will request all tax accrual workpapers. In general, the presumption should be to request all tax accrual workpapers in these situations. However, before requesting the workpapers, agents are encouraged to consult with OTSA. See Q&A 8, for more information about the discretion that should be exercised.

Q5. In what situations will the IRS request tax accrual workpapers for returns filed before July 1, 2002?

- A. For returns filed prior to July 1, 2002, the Service will, in appropriate circumstances, request tax accrual workpapers pertaining to a listed transaction if the taxpayer had an obligation to disclose the transaction under §1.6011-4T and failed to do so through any of three methods. The request will in these cases be limited to workpapers pertaining only to the listed transaction.

For purposes of the new policy, a taxpayer could have disclosed using any one of the following three methods: (1) §1.6011-4T, (2) Announcement 2002-2, and (3) Rev. Proc. 94-69.

- (1) Regulation §1.6011-4T requires the taxpayer to attach a disclosure statement to the return and send a copy of the first year's disclosure to the Office of Tax Shelter Analysis (OTSA). If there is no attachment to the return, the examiner should query the taxpayer or contact OTSA by email at otsa@irs.gov. OTSA keeps a database of all disclosures it receives. Solely for purposes of this new policy, a disclosure using Form 8275, 8275A, or a similar statement is considered adequate disclosure.
- (2) Announcement 2002-2 allowed taxpayers a limited opportunity to disclose their participation in tax shelters in return for a waiver of the IRC §6662 penalty. All disclosures made under this announcement were filed with OTSA. Examiners may contact OTSA to verify whether their taxpayer made a disclosure under this announcement.
- (3) Rev. Proc. 94-69 provides Coordinated Industry Case (CIC) taxpayers under audit an opportunity to make adequate disclosure by filing a qualified amended return. Examiners may review the qualified amended return to

determine whether disclosure was made. Note that CIC taxpayers only exist in LMSB and that Rev. Proc. 94-69 applies only to LMSB taxpayers.

- Q6. What is meant by the term “appropriate circumstances” in the memorandum from Commissioners Langdon and Kehoe, cited in Question 5 above?
- A. “Appropriate circumstances” refers to situations where requests for workpapers are justified. Circumstances that are not appropriate would be rare. For example, a circumstance that might warrant not pursuing workpapers would be if a case were in 30-day status. Another circumstance that might warrant not pursuing workpapers is where the taxpayer has fully conceded the issue. The general rule under the new policy is that examiners should request tax accrual workpapers in all cases for returns filed before July 1, 2002 if the taxpayer failed to disclose a listed transaction. If, however, there is an exceptional situation where the requirements of Announcement 2002-63 are met and the examiner decides not to pursue the tax accrual workpapers, the DFO’s approval would be required. In the case of SB/SE, approval is required from the Compliance Area Director, or the assigned designee.
- Q7. Announcement 2002-63 states that for returns filed on or after July 1, 2002, if the listed transaction was disclosed, the Service will routinely request tax accrual workpapers pertaining only to the listed transaction. However, if the transaction was not disclosed, the Service will routinely request all tax accrual workpapers. Why the different treatment?
- A. The regulations require full disclosure of listed transactions and the IRS wants to encourage compliance with the regulations. Because the Service’s confidence level is lower in cases where taxpayers do not disclose, the Service seeks to bridge this gap by routinely requesting all tax accrual workpapers in cases where taxpayers fail to observe the disclosure rules.
- Q8. For returns filed on or after July 1, 2002, the announcement states that if the taxpayer engages in multiple listed transactions or multiple investments in listed transactions, or there are financial accounting irregularities on the return, the Service will “as a discretionary matter” request all tax accrual workpapers, regardless of whether the transactions were disclosed. What does “as a discretionary matter” mean?
- A. The term “discretionary matter” as used in this context denotes the exercise of prudence in executing policies. The presumption is that in cases involving multiple listed transactions or multiple investments in one or more listed transactions, regardless of whether the transactions were disclosed, the Service will request all tax accrual workpapers. A similar presumption applies in all cases involving financial irregularities, such as those requiring restatement of earnings, where the Service will request all workpapers. There may be rare instances in which requesting all workpapers might not be appropriate. For example, if the taxpayer fully concedes all listed transactions, it probably would be appropriate not to seek

all workpapers. In all cases in which there are multiple investments in listed transactions, or financial irregularities, coordination with OTSA is required.

- Q9. What is the connection between the request for tax accrual workpapers and the mandatory Information Document Request (IDR) that Commissioner Langdon authorized for use in LMSB cases? [Larry Langdon's memo dated January 29, 2002].
- A. Agents may uncover the existence of listed transactions in any number of ways, including the issuance of the mandatory IDR and reviewing information available from OTSA. The mandatory IDR is one tool to help agents determine whether a taxpayer invested in a listed transaction that the taxpayer did not disclose. A response to the IDR that indicates that the taxpayer invested in a listed transaction provides a basis for requesting the tax accrual workpapers. [Note that the mandatory IDR is not merely for one-term issuance: it must be issued at the beginning of every cycle and re-issued every new cycle thereafter, regardless of the fact that the taxpayer was not involved in a listed transaction in the prior cycle or examination].
- Q10. If, in response to a mandatory IDR, the taxpayer says it is not involved in a listed transaction, but the agent has information that the taxpayer is, in fact, involved in such a transaction, should the agent request the workpapers?
- A. Yes, in this case the agent should request all the workpapers, because the taxpayer violated the disclosure rules. Announcement 2002-63 states that "if the listed transaction was not disclosed, the Service routinely will request all tax accrual workpapers". However, before requesting the workpapers, the agent should validate the information he or she has with OTSA and present the facts up the chain of command to the DFO level for approval. In the case of SB/SE taxpayers, substitute "Area Compliance Director" for "DFO".
- Q11. If a transaction becomes "listed" subsequent to the filing of a tax return and the transaction was not disclosed, may the tax accrual workpapers be requested?
- A. Yes, as long as at the time of the request the transaction was listed.
- Q12. For purposes of this new policy, how must taxpayers disclose their involvement in listed transactions for returns filed on or after July 1, 2002?
- A. Taxpayers must disclose their participation in a listed transaction as required under §1.6011-4T. If at the time the taxpayer files its return the transaction is either a listed transaction or an "other reportable" transaction, the taxpayer must attach a statement to its return as described in §1.6011-4T. In addition, a copy of the first year's disclosure must be filed with OTSA.
- Q13. If a transaction becomes listed after a taxpayer filed its tax return, when must a disclosure be made to be timely?

- A. If at the time the taxpayer files its return the transaction was neither a listed transaction, nor otherwise a reportable transaction, and later the transaction becomes a listed transaction, the taxpayer must attach the statement to its next filed income tax return and must send a copy to OTSA, whether or not the transaction affects the taxpayer's income tax liability for that year. Disclosure under Rev. Proc. 94-69, or a disclosure using Form 8275 or 8275R, does not satisfy the disclosure requirement for the tax accrual workpapers policy for returns filed on or after July 1, 2002.

For a return filed after June 14, 2002 and before December 11, 2002, the taxpayer must either attach the statement to its return or file the statement as an amendment to the return no later than December 11, 2002.

- Q14. If the taxpayer notifies the Service about its involvement in a listed transaction a few months after the audit is started and the benefit of that transaction was claimed on a return filed on or after July 1, 2002, must the workpapers still be requested?

- A. Yes, because the taxpayer was involved in a listed transaction and failed to disclose under the disclosure rules. In such a case, all tax accrual workpapers should be requested.

- Q15. What is meant by the statement in the Langdon/Kehoe memorandum that the change in policy for requesting workpapers is only applicable to "examination of original returns?"

- A. An original return is any return filed up to the due date of the return. It is the practice of the Service to treat as an original return an amended return filed by the return due date (including extensions). Thus, if a return with an extension to 9/15 is filed by 7/15 and a subsequent amended return filed by 9/15, the original includes the amended. If, however, an amended return is filed on 9/16, only the return filed on 7/15 is counted as an original return.

The tax accrual workpapers policy change is intended to encourage taxpayers not to engage in such transactions at all and to disclose benefits from listed transactions on their returns. If a taxpayer files its original tax return without claiming the benefits of a listed transaction, but subsequently amends its return to claim such benefits, the policy change does not apply to the examination of the amended return. Requests for tax accrual workpapers made in the course of examining an amended return are subject to the procedures described in the Appendix 1 to the Langdon/Kehoe memorandum. [See Q & A 24 below].

- Q16. Should examiners have any concerns when requesting tax accrual workpapers from a third party such as an accounting firm?

- A. An accounting firm is a third party under IRC § 7602(c), unless the firm has a valid power of attorney from the taxpayer. IRM 4.10.1.6.12 contains procedures, including the notice to be provided to the taxpayer regarding pending third-party contacts. Letter 3164 F or G, or Notice 1219 can be used for this purpose, unless notice has already been given. Any letter or notice should be addressed to an individual in the taxpayer's business that is authorized to represent the taxpayer before the Service. IRM 4.10.1.6.12.4 provides exceptions to the notification requirements.

Q17. When requesting all of the tax accrual workpapers, agents are told to "use their best judgment and apply risk analysis in using the information in the tax accrual workpapers unrelated to listed transactions as a basis for further examination of new and undeveloped issues." What does this mean?

- A. The tax accrual workpapers may provide additional support for an issue already being examined, or throw light on an entirely new issue. Use of the workpapers to enhance development of an issue already being examined is quite proper. However, if the workpapers provide information regarding a material new issue, the effect on the overall examination must be analyzed. The agent should use risk analysis and judgment to determine whether an issue is material. The examiner should carefully evaluate the overall effect of the issue on the examination, based on factors such as materiality of the new issue, its tax administration significance, its permanent or rollover tax benefit, the potential to recoup the tax benefit in a later cycle, and the existence and strength of a current legal position on the new issue. Materiality does not depend entirely on a dollar amount. A decision to examine the new issue should only be made if the applicable factors clearly weigh in favor of expanding the scope or span of the audit to include the issue currently, or to include the issue in the next cycle. To the extent the information contained in the workpapers provides a basis for opening or reopening an examination of other tax years, existing procedures governing the opening or reopening of examinations [IRM 4.4.23 or IRM 4.4.26] should be followed.

Q18. What information should we expect to find in the tax accrual workpapers?

- A. Tax accrual workpapers are typically prepared by accountants to determine and document the tax reserve amounts related to the tax position on certain transactions taken by the taxpayer. The workpapers may include an estimate of the potential tax liability for the company, with accompanying schedules as to how it was computed. In addition, there may be an audit trail and complete explanation of the transaction.

There may also be information of whether there was reliance on outside legal advice; an assessment of the taxpayer's position and potential for sustention; references to promotional materials; and comments on unwritten agreements, confidentiality agreements, restitution agreements, contingency fees, expectations, and other material facts surrounding the transactions. The workpapers may include documents written by the taxpayer's employees and officers describing or

evaluating the tax strategies. The scope and quality of the workpapers will vary between companies and auditors.

Q19. How should the tax accrual workpapers be used?

- A. Review them to determine if they are complete or if something may be missing. Discuss any possible omission with your Counsel attorney and upper management. Use the information in them to solidify your audit adjustments and request additional information. If new audit issues are uncovered, discuss the need to expand the examination with your team manager.

Q20. Whom may examiners contact for assistance on tax shelters and listed transactions?

- A. The OTSA web site on the LMSB intranet features a “contact list” that contains the names of Technical Advisors and Industry Program (IP) Counsel for each listed transaction. Agents should contact them for advice and assistance. In addition, Technical Advisors have individual web sites that have the latest tax shelter information relative to their areas of expertise. These should be reviewed prior to contacting the Technical Advisor. With regard to general tax shelter help, OTSA has an abundance of information on its database that is not available elsewhere. OTSA can also facilitate additional guidance on technical and policy matters that you may not be able to get from other sources.

Q21. What is OTSA’s role concerning tax accrual workpapers?

- A. OTSA is available to provide guidance and assistance to field and other personnel and answer questions that might arise during the implementation of this new policy. OTSA maintains databases containing information on disclosures under Reg. §1.6011-4T and Announcement 2002-2, as well as a database of tax shelter registrations. Due to its close working relationship with the Office of Chief Counsel and Treasury’s Office of Tax Policy in evaluating the tax treatment of new and emerging forms of tax-structured transactions, OTSA has accumulated information on tax shelters that is not readily available elsewhere, and agents are encouraged to make maximum use of its resources. Information on how to contact OTSA is available on the OTSA website. OTSA may also be contacted by e-mail at otsa@irs.gov.

Q22. What is the procedure for making the request for tax accrual workpapers?

- A. The request for the tax accrual workpapers should be made after the agent determines that the taxpayer claimed a tax benefit arising out of one or more listed transactions. The extent of a taxpayer’s investment(s) in listed transaction(s) will determine the scope of the request for the tax accrual workpapers.

Determining the taxpayer’s investments in listed transactions should be initiated at the beginning of the audit. First, the agent should determine whether any of the

transactions disclosed by the taxpayer is a listed transaction. Second, the agent should issue the mandatory IDR to determine if the taxpayer invested in any listed transaction that the taxpayer did not disclose on its return. Third, the agent should contact OTSA to determine if it has any information about whether the taxpayer invested in a listed transaction. Of course, information about a taxpayer's involvement in a listed transaction may arise from other sources as well, and should be considered by the agent.

Once the agent determines that the taxpayer was involved in one or more listed transactions, the agent should work with Counsel to prepare a request for the tax accrual workpapers. In all cases in which a decision has been made to request the tax accrual workpapers, agents must give the taxpayer advance notice of their intention to request the workpapers. They should also refer the matter to their team managers for review and elevation up the chain of command to the DFO level. In the case of SB/SE taxpayers, the matter should be elevated to the Area Compliance Director, with the concurrence of the Director of Compliance Policy. The DFO's or Area Compliance Director's approval must be obtained before issuing the request for tax accrual workpapers.

Q23. The Langdon/Kehoe memorandum states that tax accrual workpapers will be requested if a taxpayer was involved in a listed transaction, or a transaction that was "substantially similar" to a listed transaction. What is meant by the term "substantially similar"?

A. Treasury Decision 9000, issued June 14, 2002 modified regulations §§ 1.6011-4T and 301.6111-2T to clarify the term "substantially similar". The clarification construes the term to include any transaction that is expected to obtain the same or similar types of tax benefits as a listed transaction, and that is either factually similar or based on the same or similar tax strategy. It also cautions that "substantially similar" must be broadly construed in favor of disclosure. Agents are encouraged to consult with local counsel or OTSA if they need further guidance.

Q24. What are the procedures outlined in Appendix 1?

A. Appendix 1 explains the current procedures for requesting audit and tax accrual workpapers. These procedures apply to returns filed prior to July 1, 2002 and to amended returns. Appendix 1 defines the terms "audit workpapers" and "tax accrual workpapers". Below is an extract from Appendix 1 dealing with these matters:

Audit workpapers and tax accrual workpapers 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 audit workpapers, whether 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. Tax accrual workpapers 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.

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 would 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.