

FIN 48 and Tax Accrual Workpapers – A New LMSB Approach?*

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Two IRS documents issued earlier this year provide insights into how the IRS will use existing FIN 48 disclosures and how the IRS may be re-evaluating its long-standing "policy of restraint" on tax accrual workpapers ("TAW"). The documents released by Deborah Nolan, Commissioner of the Large and Mid-Size Business Division ("LMSB"), are (1) a memorandum to all LMSB executives, managers, and examiners on "FIN 48 and Tax Accrual Workpaper Policy Update" and (2) "FIN 48 Implications - LMSB Field Examiners' Guide."

Policy Update on FIN 48 and TAW

IRS Objectives -- Nolan's memorandum discusses the impact of FIN 48 developments on LMSB. She explains that her intent is to provide a consistent and clear message on the IRS's current TAW policy and to communicate developments that examiners should anticipate in the future.

In her memorandum, Nolan states that examiners are to review public documents, including FIN 48 financial statement disclosures, when conducting a risk analysis in the audit planning process. Nolan specifically directs examiners to discuss with taxpayers any information found in the financial statements concerning taxes "that may raise a red flag."

***Observation:** This has put LMSB examiners on notice that the public disclosures exist, that the examiners are expected to review these disclosures in conducting their risk analysis, and that examiners are expected to pursue any issue that raises a "red flag." As a result, corporate tax executives can expect examiners to review carefully the company's disclosures and to begin asking questions relative to those disclosures.*

LMSB believes that there should be an increased level of transparency between corporate America and the IRS given the increased transparency and disclosure required of public companies by regulatory authorities. Therefore, it is not surprising that Nolan noted in her memorandum that Chief Counsel has determined that FIN 48 workpapers are considered TAW and hence subject to the current policy of restraint. She then comments that LMSB is reviewing its TAW policy of restraint to determine if it is still "appropriate" in today's environment.

***Observation:** This public acknowledgment of the policy review has set the stage for public debate of the issue.*

TAW Cadre -- In the document, Nolan introduces a new term – the "TAW Cadre." The TAW Cadre, under the authority of the Pre-Filing and Technical Guidance Office of LMSB, consists principally of experienced external hires from corporate tax departments. TAW Cadre members will be available to consult with examiners in obtaining TAW under the current LMSB policy and assisting them in their review of documents received in response to TAW Information Document Requests.

Training -- Finally, the memorandum notes that LMSB will be introducing a new mandatory six-hour training program between June and November 2007. The topic of the training will be FIN 48 disclosures and how the information is to be used in an LMSB examiner's risk analysis. This mandatory training, along with the formation of the TAW Cadre, has sent a clear message to examiners that they are expected to look at the FIN 48 disclosures and pursue any issue that raises a "red flag."

***Observation:** It is interesting to note that much of the discussion in Nolan's memorandum concerns the use of disclosure information for purposes of the IRS risk assessment. Based on this reading, one is left with the impression that LMSB will be using the information solely for purposes of the risk assessment until examiners have gained more experience in the area.*

LMSB Field Examiners' Guide

FIN 48 Implications -- Much of the information contained in the Guide is background information on FIN 48 and its related implementation, with LMSB views and issues presented at the end in a question and answer format. LMSB Field Examiners' Guides historically have been developed and widely distributed throughout LMSB to provide guidance and direction to field personnel relative to a new area or existing area that has caused confusion or uncertainty in implementation. As with the FIN 48 Guide, these documents often use a question and answer format to address questions raised by LMSB personnel.

In the new Guide, examiners once again are encouraged to discuss any questions raised through their review of FIN 48 disclosures with the taxpayer. However, they are reminded of the policy of restraint on TAW and are directed to "not cross over the boundaries continued therein."

Observation: *In light of the fact that many examiners have no corporate tax department experience and that few may have seen TAW, the typical examiner may have questions as to how to comply with these guidelines. On the one hand, the examiner is instructed to review and pursue issues identified in the disclosures, while on the other hand the examiner is instructed to follow the policy of restraint relative to the TAW that contain the information supporting the disclosure. This could lead to some agents asking to be educated on the company's tax provision process, others inappropriately asking for TAW, and yet others simply performing a quick check and moving on to other areas.*

Reopening Exams -- Of particular note in the Guide is the question whether the IRS will reopen an exam cycle that previously was closed as a result of the disclosures made in the financial statements. While not specifically stated, it is implied that the hypothetical taxpayer referred to in the question released a material tax contingency reserve liability related to issues in a recently closed IRS exam cycle. The question is answered by reiterating the long-standing policy that the IRS generally does not reopen tax years that have been examined and closed in accordance with Policy Statement P-4-3 (12-21-84) and Internal Revenue Manual provision 1.2.1.4.1.

Although rarely done, a case may be reopened when:

1. There is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact;
2. The case involves a clearly defined, substantial error based upon an established IRS position at the time of the examination; or
3. Other circumstances exist indicating that failure to reopen would be a serious administrative omission.

The Guide indicates that the IRS has no intention of modifying its policy on examination reopenings. At the same time, the Guide points out that FIN 48 requires more information to be disclosed about uncertain tax positions and that it is "possible that reopenings will occur more frequently because of the potentially increased availability of information warranting reopening."

Observation: *Although there is no apparent movement to change the reopening policy, the IRS's speculation that it is "possible that reopenings will occur more frequently" could create additional uncertainty for some corporate taxpayers with respect to issues in closed examination cycles.*

Conclusion

While not companion documents, the Nolan memorandum and the Field Examiners' Guide are clearly related. When read together, these two documents provide insights into how the IRS will use existing FIN 48 disclosures and give taxpayers a hint with respect to the direction the IRS may be leaning in re-evaluating its long-standing policy of restraint on TAW.

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