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MEMORANDUM

Re: IRS Clarifies Position on Workpapers

From: Peter H. Winslow
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Date: July 19, 2004

Recently, the IRS issued changes to the Internal Revenue Manual ("IRM") to elaborate on its policy on requesting workpapers in audits. Previously, in Announcement 2002-63, 2002-2 C.B. 72, the IRS stated it may request tax accrual workpapers in the course of examining any return after June 30, 2002 that claims any tax benefit arising out of a transaction that the IRS has determined to be a listed transaction. The new IRM provisions expound on this announcement and provide definitions for audit workpapers, tax accrual workpapers, and tax reconciliation workpapers and explain the IRS policy and procedures for requesting each type.

Tax Reconciliation Workpapers

IRM 4.10.20 defines tax reconciliation workpapers as those used in assembling and compiling financial data preparatory to placement on a tax return, and typically include final trial balances for each entity and a schedule of consolidating and adjusting entries. The IRS will request tax reconciliation workpapers as a routine matter at the beginning of an examination. If these workpapers are unavailable from the taxpayer, the IRS will seek to obtain them from the taxpayer's accountants.

Audit Workpapers

Audit Workpapers are defined as workpapers created by or for the independent auditor, which include information about the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to the independent auditor's review of the taxpayer's financial

July 19, 2004

Page 2

statements. The IRM states that audit workpapers should be requested with discretion and not as a matter of standard examining procedure. Instead, agents should apply the “unusual circumstances” standard in determining whether audit workpapers should be requested. “Unusual circumstances” exist under the following conditions: 1) a specific issue has been identified for which there exists a need for additional facts; 2) the IRS has sought from the taxpayer and available third parties all the facts known to them relating to the identified issue; and 3) the IRS has sought a supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue and has performed a reconciliation of the taxpayer’s Schedule M-1 or M-3 as it pertains to the identified issue.

Tax Accrual Workpapers

Tax accrual workpapers are those audit workpapers that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax reserves on audited financial statements. The IRS policy governing requests for tax accrual workpapers varies according to the time the tax return was filed and whether the workpapers involve a listed transaction.

Requests for tax accrual workpapers that do not involve a listed transaction, or any request for tax accrual workpapers involving a listed transaction for returns filed on or before February 28, 2000 are governed by the “unusual circumstances” standard described above. Requests for tax accrual workpapers involving a listed transaction for returns filed after February 28, 2000 but before July 1, 2002 will be made if the taxpayer was required to disclose the listed transaction and failed to do so. In general, requests with respect to undisclosed listed transactions will be limited to the tax accrual workpapers for the years under examination, or to other years that may be directly relevant to the years under examination. Requests for tax accrual workpapers involving a properly disclosed listed transaction for returns filed on or after July 1, 2002 will be made for the year under examination, or other years if directly relevant. However, if a listed transaction was not timely and properly disclosed, the IRS will routinely request all tax accrual workpapers for the year under examination, or to other years that may be directly relevant to the years under examination. Finally, the IRS will request all tax accrual workpapers for the year under examination if it determines that the taxpayer claimed tax benefits from listed transactions and there are reported financial irregularities with respect to the taxpayer.

The IRM also cautions that the name given the workpapers by the taxpayer, the taxpayer’s accountant, or the independent auditor is not determinative. In addition, the IRS warns that tax reconciliation workpapers do not become tax accrual workpapers when they are used in the preparation of tax accrual workpapers or are attached to tax accrual workpapers. Preexisting documents that the taxpayer, the taxpayer’s accountant, or the taxpayer’s independent auditor consults, refers to, or relies upon in making evaluations or decisions regarding the tax reserves or in performing an audit are not themselves considered tax accrual workpapers or audit workpapers, even though the taxpayer, the taxpayer’s accountant, or independent auditor may store such documents with the tax accrual workpapers or audit workpapers.

Please call with questions.