Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **AM 2007-0012**

Release Date: 6/8/07

UILC: 9999.00-00

date: March 22, 2007

to: Deborah M. Nolan
Commissioner, Large and Mid-Size Business Division

from: Donald L. Korb
Chief Counsel

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subject: FIN 48 & Tax Accrual Workpapers

This memorandum addresses the issue of whether documents produced by the taxpayer and/or its auditors to substantiate the taxpayer's uncertain tax positions in compliance with FIN 48 are included within the Service's interpretation of Tax Accrual Workpapers (TAW) as provided in IRM Section 4.10.20.2 (2). As discussed below, FIN 48 and the other Financial Accounting Standards Board (FASB) pronouncements articulate financial accounting and reporting requirements. However, neither FIN 48, nor other relevant FASB pronouncements, prescribe documentation requirements. Rather, the documentation requirements that taxpayers and their auditors must follow are established by the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the American Institute of Certified Public Accountants (AICPA), and these documentation requirements remain unchanged by the issuance of FIN 48. Consequently, it is our conclusion that documentation resulting from the issuance of FIN 48 is considered tax accrual workpapers for purposes of IRM Section 4.10.20.2(2).

IRM Section 4.10.20.2(2) defines tax accrual workpapers as "those audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant or the independent auditor, 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." These workpapers reflect an estimate of a company's tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis, or tax contingency reserve analysis. The name given the workpapers by the taxpayer, the taxpayer's accountant, or the independent auditor is not determinative. Tax accrual workpapers typically include determinations and related documentation of estimates of potential or contingent tax liabilities related to tax positions taken by the taxpayer on certain transactions. In addition, there may be an audit trail and/or complete explanation of the transactions. There may also be information on 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.[1]

FASB Statement No. 109 (Accounting for Income Taxes, effective 1992) established financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. It requires an

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[1] IRM Section 4.10.20.2(2) also provides that the total amount of the reserve established on a company's general ledger for all contingent tax liabilities of the company for a specific reporting period is not considered a part of the company's tax accrual workpapers. An examiner may ask a taxpayer about the existence and the total amount of a reserve for all contingent tax liabilities as a matter of routine examination procedure, without a showing of unusual circumstances and without seeking executive approval for the request. In addition, it provides that a request to reveal the existence or amount of a tax reserve established for any specific known or unknown transaction, however, is the same as asking for a description of a portion of the contents of the tax accrual workpapers. Requests for a description of the contents of the tax accrual workpapers are covered by the same policy of restraint as requests for the actual documents that make up the tax accrual workpapers.

IRM Section 4.10.20.2(1) defines Audit Workpapers as workpapers created by or for the independent auditor. They are retained by the independent auditor and may be shared with the taxpayer. These workpapers include information about the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to the independent auditor's review of a taxpayer's financial statements. 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 and generally accepted accounting principles.

IRM Section 4.10.20.2(3) defines Tax Reconciliation Workpapers as workpapers are used in assembling and compiling financial data preparatory to placement on a tax return. These papers typically 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. Any tax return preparation documents that reconcile net income per books or financial statements to taxable income are also tax reconciliation workpapers. 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 a 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.

asset and liability approach to financial accounting and reporting for income taxes. The objectives of accounting for income taxes are to recognize (a) the amount of taxes payable or refundable for the current year and (b) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns. FASB No. 109 established procedures to (i) measure deferred tax liabilities and assets using a tax rate convention and (ii) assess whether a valuation allowance should be established. All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of a deferred tax asset. Judgment must be used in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified.

FASB Interpretation No. 48 (FIN 48) (Accounting for Uncertainty in Income Taxes, effective December 15, 2006) interprets FASB Statement No. 109 and clarifies the accounting for uncertainty in income taxes. It is intended to provide a more consistent approach to accounting for income taxes. The interpretation prescribes a recognition threshold and a measurement attribute. It requires a two step analysis. First, the enterprise determines whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should assume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. If a tax position meets the more-likely-than-not threshold, the second step is to measure the amount of benefit to recognize in the financial statement. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement (cumulative 50% test). FIN 48 requires an enterprise to make certain disclosures at the end of each annual reporting period.[2]

Documentation Considerations

FASB No. 5, FASB No. 109 and FIN 48 articulate accounting and reporting principles with respect to accounting for contingent liabilities, income taxes and contingent tax liabilities. While they provide different standards for accounting for such items (i.e. different thresholds for recognizing the liabilities and calculating the amount of such liability), none of those provisions set forth specific record keeping or documentation requirements necessary to comply with those provisions.[3] Rather, the documentation requirements for the auditors are set forth by the SEC, PCAOB and AICPA.

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[2] FIN 48 requires the disclosure of a tabular reconciliation of the total amounts of unrecognized tax benefits, the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate, total amounts of interest and penalties, positions for which there is a reasonable possibility that the total amounts of unrecognized tax benefits will significantly increase of decrease within 12 months of the reporting date, and a description of the tax years that remain subject to examination by major tax jurisdiction.

[3] See December 13, 2006, Speech by SEC Staff Regarding Remarks before the 2006 AICPA National Conference on Current SEC and PCAOB Developments at www.sec.gov/news/speech/2006

SEC Reg. S-X, Article 2, 210.2-06 (attached) requires that auditors retain for a period of seven years records relevant to the audit or review, including workpapers and other documents that form the basis of the audit or review of the issuer's financial statements, and memoranda, correspondence, communications, other documents, and records (including electronic records), which are created, sent or received in connection with the audit or review and contain conclusions, opinions, analyses, or financial data related to the audit or review.

The PCAOB established auditing standards that require registered public accounting firms to prepare and maintain, for at least seven years, audit documentation "in sufficient detail to support the conclusions reached" in the auditor's report.[4] The PCAOB adopted as interim standards AICPA Auditing Standard No. 95, (attached) which sets forth auditor documentation requirements. Auditing Standard No. 95 provides that the auditors must obtain sufficient competent evidential matter through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

The PCAOB also adopted AU Section 9326, Evidential Matter: Auditing Interpretations of Section 326 (attached). AU Section 9326 specifically addresses the audit of tax liability contingency analysis. It provides that auditor's documents should include sufficient competent evidential matter about the significant elements of the client's tax liability contingency analysis, including "copies of the client's documents, schedules, or analyses (or auditor-prepared summaries thereof) to enable the auditor to support his or her conclusions regarding the appropriateness of the client's accounting and disclosure of significant tax-related contingency matters…The audit documentation should include the significant elements of the client's analysis of tax contingencies or reserves, including roll-forward of material changes to such reserves. In addition, the documentation should provide the client's position and support for income tax related disclosures."[5]

Conclusion

None of the relevant FASB pronouncements, including FIN 48, prescribe documentation that the taxpayer and/or its auditors must produce, maintain or rely upon in evaluating uncertain tax positions. Rather, the documentation requirements that taxpayers and their auditors must follow are established by the SEC, PCAOB, and the AICPA and are unaffected by the issuance of FIN 48. Moreover, these documentation requirements have not been changed since the issuance of FIN 48. Accordingly, the issuance of FIN 48 does not change whether a document is considered to be a tax accrual workpaper as defined by IRM Section 4.10.20.2(2).

/spch121306jmg.htm.

[4] See PCAOB Auditing Standards No. 1 & 3 (attached).

[5] The relevant portions of AU Section 9326 were issued in March, 1981, and amended April 9, 2003, and also discuss the concern over the IRS's access to tax accrual workpapers and its potential effect on taxpayers to not prepare or maintain appropriate documentation of the calculation or contents of the accrual for income taxes. See Section 2.06-2.09.

Commissioner of Internal Revenue
cc: Division Commissioners (LMSB), (SBSE) & (TEGE)
Deputy Chief Counsel (Operations) & (Technical)
Division Counsel (LMSB), (SBSE) & (TEGE)
Special Counsel to the Chief Counsel