is earned sometimes can be. Rules are needed to determine when taxpayer arrangements that defer vesting will be respected and to determine the appropriate treatment of compensation that accrues over multiple periods, as with severance pay and supplemental executive retirement plans. But those rules are necessary under the section 409A approach, too. On balance it seems likely that the threshold problem of defining deferred compensation, like so many issues, would be less severe under the special tax approach compared with the same problem under current law.

In conclusion, we would appreciate comments on whether we have the policy correct — in particular, our evaluation of the four ways deferral could be said to result in tax avoidance. Also, we seek reaction to our approach to fashioning a special tax on investment income.

Blame It on Transparency

By Brian R. Lynn

Brian R. Lynn is an associate at Caplin & Drysdale, Chartered in Washington.

The IRS is relaxing its "policy of restraint" on requesting tax accrual workpapers again.

Large and Midsize Business Division (LMSB) Commissioner Deborah Nolan said on February 1 that the IRS is considering revamping its policy of not asking for a company's tax accrual workpapers during an exam. And Nolan's deputy, LMSB Senior Adviser Bob Adams, reiterated this comment on February 8, stating that the IRS is considering changing the policy in light of Financial Accounting Standards Board Interpretation No. 48 (FIN 48), which recently went into effect. (See *Tax Notes*, Feb. 12, 2007, p. 614.)

FIN 48 changes the accounting rules for uncertain tax positions. It restricts when companies can recognize tax benefits on their financial statements and requires companies to do a detailed issue-by-issue analysis of their tax positions. FIN 48 will likely create new documents that show the thinking of in-house and outside tax advisers on some transactions. These documents will become part of the auditor's tax accrual workpapers because the auditors will need to review them to sign off on the financial statements.[1] FIN 48 may also push outside auditors to require tax opinions on sensitive transactions — and these opinions would likely be part of the workpapers too. The IRS could use the new documents to spot issues and find soft spots in a company's tax return. In other words, FIN 48 creates a potential gold mine for a revenue agent.

This potential policy change is part of the burgeoning war on the tax gap. No one in Washington wants to raise taxes or cut spending, so the new (old) solution is to collect all of the taxes owed from the bad people — often big companies — who aren't paying their taxes. That story plays well back home in Iowa and Montana. And the IRS and Treasury have joined the party with new proposals to whittle down the tax gap.

If you are thinking that this story sounds familiar, you're right. Five years ago, the enemy wasn't the tax gap — it was tax shelters. Abusive tax shelters proliferated in the late 1990s, and Congress and the IRS responded to the tax shelter problem like a stood-up prom date. They tightened the disclosure regime, set up the Office of Tax Shelter Analysis, listed every transaction in sight, and imposed stiff penalties for reporting failures. The IRS also decided that the reasons for not asking for tax accrual

[1]IRS officials have said that FIN 48 supporting documents will be part of the tax accrual workpapers. For details on what is included in tax accrual workpapers, see CC 2004-010 and IRM section 4.10.20.2(2).

workpapers were not compelling enough when a company failed to disclose one or more listed transactions. So in 2002 the IRS revised its policy and began asking for tax accrual workpapers in these cases.[2]

These policy reversals show two things. On the surface, they reveal that the IRS has a fairly weak policy of restraint on tax accrual workpapers. (Larry King has a similar "policy of restraint" on marriages.)

The deeper concern is the push toward a self-audit tax system for large companies. We have self-assessment, but we are not supposed to have a self-auditing system. In a sense, FIN 48 makes companies audit their own tax returns and write up a detailed audit report — down to percentages of success — on every uncertain tax position. FIN 48 also requires companies to self-report penalties and interest. Maybe the FIN 48 workpapers will not end up looking like a draft 30-day letter. (That is largely up to the outside auditors, who must get comfortable that the company is complying with FIN 48 to sign the audit opinion.) Most agree, however, that the FIN 48 workpapers will include more analysis than today's tax accrual workpapers.

The IRS's official rationale for its position change is "transparency." Nolan and Adams gave that as the reason for changing the tax accrual workpaper policy; and IRS Chief Counsel Don Korb likes to say that "sunshine is the best disinfectant." The idea is that the IRS is just trying to prevent companies from hiding transactions and questionable tax positions.

Transparency is a laudable goal, and the IRS should try to establish a more transparent tax reporting system. The IRS has the right to learn what a taxpayer did without playing the shell game. A transparent system ensures horizontal equity between taxpayers — which is an important public policy goal of any tax administration system.

Sometimes transparency provides a good explanation for IRS policy decisions. For instance, transparency explains why the IRS and Congress ratcheted up the disclosure regime five years ago. With shelters and listed transactions, the transparency rationale works because the reportable transaction regime is just a way to send a mass information document request to all taxpayers asking them if they have done any of the enumerated transactions. It is an effort to learn what a taxpayer did. That fits the goal of a more transparent tax system because the IRS literally learns who did what. Transparency also explains the IRS's rollout of the Schedule M-3, which provides a detailed reconciliation of a company's book and tax incomes.

Transparency doesn't justify everything, however. It doesn't explain the IRS's decision to routinely ask for a company's FIN 48 workpapers. Transparency means "the full, accurate, and timely disclosure of information." Taxpayers should disclose the *information* related to their activities. They should provide all of the financial data, contracts, and supporting documents that the IRS requests. They should even disclose the e-mails that reveal what the employees were thinking when they performed a specific transaction. But taxpayers should not have to systematically reveal their subjective thoughts about the strengths and weaknesses of every position on their tax return. The IRS does not sit down and ask a company's tax director to identify all of the soft spots on the company's return. That goes beyond requesting information. It is self-auditing — not transparency.

Granted, the IRS is not forcing taxpayers to perform this self-audit. FASB is doing it through FIN 48, and the IRS is just tapping into the company's self-audit by requesting the accountant's tax accrual workpapers. The IRS does not have to use every tool at its disposal, however. Requesting the tax accrual workpapers will make the IRS's job easier (less time issue-spotting, better 30-day letters) — but that, in and of itself, is not enough of a reason to change the current policy. FIN 48 is a reason *for* the IRS's policy of restraint on tax accrual workpapers, not a reason to abandon the policy.

Requesting tax accrual workpapers in routine exams will also damage the relationship between a company and its in-house and outside tax advisers. It essentially forces the advisers to become agents of the government because the company's tax advisers must explain in writing all of the weak spots on the return for the outside auditor. That puts the tax advisers in the difficult position of trying to provide an honest evaluation of the issue — while also knowing that the IRS will ultimately see their write-up and possibly use it against the company.

As a result, tax advisers may be tempted to write a rosier review of the issues than they otherwise would, for two reasons. First, a rosy memo on an issue may dissuade the revenue agent from delving into that issue. Second, these internal memos can become a self-fulfilling prophecy. For example, Company X might have expensed the costs related to the acquisition of a subsidiary up to a certain date. The IRS might think that Company X should have started capitalizing the costs earlier. If Company X's tax director writes up the issue for the FIN 48 workpapers and recites all of the facts that support the earlier date, the IRS might just pick that earlier date and make an audit adjustment. The tax director will know that, and my guess is that tax directors will choose their words carefully (or just ignore the downsides) when writing up the issue. That dynamic will impede the open communication between the company and its auditor.

Finally, changing the workpaper policy will also prejudice big companies. FIN 48 applies only to larger companies, which tend to get generally accepted accounting principle audits. Small, unaudited companies will not have to create FIN 48 workpapers — and thus will not have to give the IRS a road map for their exams. And small businesses tend to have lower compliance rates than large companies. If the target is the tax gap, the IRS is in some ways aiming at the wrong target with this proposed policy change.

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[2]Ann. 2002-63, 2002-2 C.B. 72, *Doc 2002-14466, 2002 TNT 117-12. See also* IRM section 4.10.20.3.2. The IRS's prior position on tax accrual workpapers is at Ann. 84-46, 1984-1 IRB 18.