ANALYSIS OF FIN 48: UNCERTAIN TAX POSITIONS

By James R. Browne, Esq., CPA, a partner with Strasburger & Price, LLP, Dallas, Texas. With more than 20 years experience in the area of taxation, he advises clients on the U.S. income tax aspects of domestic and international business transactions. He has served as chief tax officer for several large publicly traded multinational companies, and was a partner with a Big 4 accounting firm.

The views expressed in this article are solely those of the author, and are not intended as legal or accounting advice.

The Financial Accounting Standards Board recently issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*,[1] completing over two years of work on the topic of financial reporting for uncertain tax positions. The new rules will be effective for periods beginning on or after December 15, 2006, meaning that most reporting entities will be required to adopt the new rules in their first quarter 2007 financial statements.

FIN 48 contains a number of helpful clarifications related to uncertain tax positions. But the most significant aspects of FIN 48 – a ''more-likely-than-not'' standard for initial recognition of tax positions, presumption of audit detection, and measurement of recognized tax benefits based on the largest amount that has a greater than 50 percent likelihood of realization – will create many implementation problems and will cause many issuers of GAAP financial statements to significantly overstate their ultimate tax liabilities.

[FIN 48] will create many implementation problems and will cause many issuers of GAAP financial statements to significantly overstate their ultimate tax liabilities.

BACKGROUND

Existing Rules

Generally accepted accounting principles (''GAAP'') applicable to accounting for income tax positions currently operate as follows:[2]

- Tax assets and liabilities must initially be recorded in accordance with the tax returns filed or to be filed by the enterprise.
- FAS 109[3] requires a valuation allowance for any deferred tax asset if it is more likely than not that any recorded tax assets will not be realized. If a tax position results in an immediate (current) tax benefit (e.g., reduction in taxes otherwise currently payable), it is deemed to be realized. If a tax position will result

[1] The interpretation (hereinafter referred to as ''FIN 48'') was released on July 13, 2006, and is available at http://www.fasb.org/pdf/fin%2048.pdf.

[2] *See generally* James R. Browne, *Financial Reporting for Uncertain Tax Positions*, 109 Tax Notes 77 (Oct. 3, 2005).

[3] FASB Statement No. 109, *Accounting for Income Taxes.*

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

in a deferred tax asset (e.g., net operating loss carryforward), the valuation allowance analysis looks to whether there will be sufficient taxable income of the appropriate character, or other tax attributes, to realize the deferred tax asset. The risk that the underlying tax position will be disallowed is generally not considered in evaluating whether the deferred tax benefits flowing from that tax position will be realized.

- FAS 5[4] requires that a loss contingency reserve be accrued if:
  - (1) it is probable that the tax position will be challenged,
  - (2) it is probable that the future resolution of the challenge will confirm that a loss has been incurred, and
  - (3) the amount of such loss can be reasonably estimated.[5]
- FAS 5 requires that a gain contingency (e.g., disputed claim for refund) not be recognized unless and until it is substantially certain that future events will confirm that the gain has been realized.

In short, under existing GAAP, the tax benefit of a tax position is generally recognized in the financial statements in accordance with the tax return reporting, and that tax benefit is not offset by any valuation allowance or contingency reserve unless (1) it is more likely than not that the benefit will not be *realized*, or (2) it is probable that the tax benefit will be challenged and *disallowed* by the IRS or other tax authority.

Reasons for Change

FIN 48 states that new rules were needed because FAS 109 provides no specific guidance on how to account for uncertainty in income taxes, and therefore diverse accounting practices developed compromising the comparability of financial statements.[6] Specifically, some entities recognized tax positions on an ‘‘as filed’’ basis in accordance with the discussion above, but some entities recognized tax benefits only when the underlying position met a threshold requirement for recognition.[7]

The stated reasons for issuing FIN 48 are difficult to reconcile with the radical changes it effects.

The stated reasons for issuing FIN 48 are difficult to reconcile with the radical changes it effects. If the Board was really concerned with assuring clarity, consistency, and comparability, it could have simply explained and reinforced existing GAAP in accordance with the discussion above. Instead, the Board chose to throw out the existing rules and substitute entirely new rules. Why?

Clearly, the Board felt that the existing rules were flawed and needed to be changed. This view was undoubtedly a reaction to the Enron investigation and related Congressional inquiries into tax shelters. Those investigations revealed that Enron and others sometimes engaged in highly aggressive tax planning

[4] FASB Statement No. 5, *Accounting for Contingencies.*

[5] If the reasonable estimate of the loss is a range, and some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount should be accrued. When no amount within the range appears at the time to be a better estimate than any other amount within the range, the minimum amount should be accrued. *Id.*

[6] FIN 48, Summary.

[7] FIN 48, ¶¶ B2-B6.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

transactions for the principal purpose of generating financial earnings.[8] SEC officials, Congressional leaders, and Board members apparently concluded that the existing rules were too flexible and led to systematic underreporting of income tax liabilities (and overstatement of future tax benefits).[9] Three aspects of the current rules under FAS 5 might have led to this perception:

(1) the probable threshold for recognition of a loss,

(2) the low end of the range estimation method, and

(3) the relatively limited disclosure requirements.

Despite these features of FAS 5, there was no empirical evidence that the current rules were causing entities to systematically understate their income tax liabilities, and there is some evidence that the opposite was true.[10] Although there might have been instances of abuse, it appears that in the vast majority of cases, the existing rules were being conservatively and consistently applied.

In sum, neither the stated reason for issuing FIN 48, nor any unstated perception of deficiencies in the current rules, justifies the radical changes imposed by the new interpretation.

EXPLANATION AND ANALYSIS OF FIN 48

Scope

FIN 48 applies to all tax positions accounted for in accordance with FAS 109. Tax positions include:

- a decision not to file a tax return;
- an allocation or a shift of income between jurisdictions;
- the characterization of income or a decision to exclude reporting taxable income in a tax return;
- a decision to classify a transaction, entity, or other position in a tax return as tax exempt.

The unlimited scope of FIN 48 could significantly increase the compliance burden of affected entities. Whereas tax positions are currently presumed to be correct, under the new rules affected entities apparently will be required to identify and analyze each and every tax position taken (or not taken) in every tax return filed (or not filed) in every jurisdiction imposing an income tax, and will require that the entity establish that each such tax position will more likely than not be sustained, even where there may be no evidence that the position will be challenged. While the required level of documentation for ''highly certain tax posi-

[8] *See* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations*, vol. 1, p. 26 (February 2003).

[9] *See* Randolph P. Green, SEC Office of Chief Accountant, *2003 Thirty-First AICPA National Conference on Current SEC Developments* (Dec. 11, 2003), *available at* http://www.sec.gov/news/speech/spch121103rpg.htm#9; Letter from Sen. Carl Levin to the Financial Accounting Standards Board (Aug. 30, 2005), available at http://www.fasb.org/ocl/1215-001/33714.pdf.

[10] *Cf.* 84 TAXES—THE TAX MAGAZINE, CCH, at p. 34 (June 2006) (less than 5 percent of respondents to a survey of Fortune 500 companies reported additional tax expense upon settlement of their most recent federal tax audit).

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

tions'' may be quite low,[11] FIN 48 imposes a burden that does not currently exist in many cases. For example, under existing rules, the risk that a state or foreign jurisdiction might assert that an entity is taxable would generally not be evaluated and documented in the financial statement workpapers unless there was some reason to believe that such an assertion was probable. In contrast, under the new rules the entity must apparently document the basis for refuting any such assertion if it were made.

It appears that the Board did not intend that FIN 48 would significantly increase the compliance burden of affected entities.[12] This suggests that an entity's tax returns, coupled with adequate internal controls for identifying tax exposures, should be sufficient to document that the entity meets the recognition and measurement requirements with respect to its tax positions, absent some evidence that uncertainty with respect to a particular tax position has not been appropriately addressed.[13]

Gain Contingencies. An anomaly under existing GAAP is the differing treatment of loss contingencies and gain contingencies, and the effect this has when a tax dispute changes from being a deficiency proceeding (loss contingency) to a refund proceeding (gain contingency). In a deficiency proceeding, the entity might have accrued the low end of the range of possible loss while the matter was pending before the tax authority. If the matter cannot be resolved, the entity might have the choice of suing for a determination prior to payment of the proposed deficiency (e.g., petition to Tax Court) or a payment and suit for refund (e.g., complaint in District Court). If the prepayment appeal is elected, the existing loss contingency accrual would generally be unaffected. In contrast, if a refund suit is pursued, the matter is probably treated as a gain contingency and the entity would likely have to fully reserve the amount in dispute until a final decision is rendered. Thus, the financial reporting for these two types of appeals might influence the entity's choice of remedies.

FIN 48 appears to eliminate this anomaly by treating all uncertainties related to taxes consistently. Whether the matter is contested in deficiency or refund proceedings, the entity would accrue the largest amount that it expects to realize upon resolution of the matter (assuming the tax benefit qualifies for recognition in the first place).

Although the distinction between loss contingencies and gain contingencies related to income taxes is apparently eliminated, an entity should nevertheless con-

---

[11] *See* FIN 48, ¶ A20. For example, an item that is reported consistently for book and tax purposes (e.g., book expense item deducted for tax purposes) may not need to be documented beyond the documentation maintained for the book treatment of the item where there are no collateral issues associated with the tax treatment (e.g., source or character). Similarly, a position that an entity is not subject to tax in a foreign country may be documented by documentation generated in the ordinary course of business showing where the entity has property, employees, or sales.

[12] *Cf.* FIN 48, ¶ B12 (''The Board does not anticipate that this Interpretation will have a significant effect on how enterprises account for tax positions that are routine business transactions that are clearly more likely than not of being sustained at their full amounts upon examination . . . .'').

[13] Implementation guidance recently issued by one of the major accounting firms supports the view that FIN 48 requires documentation and analysis only with respect to tax positions ''for which the sustainability of the position, based upon the technical merits, is uncertain.'' PricewaterhouseCoopers, *FIN 48 Client Action Plan: Accounting for uncertainty in income taxes*, p. 9 (Sept. 11, 2006).

 COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

sider whether its expected recovery is adversely affected once it has paid the proposed deficiency. For example, in some cases states have refused to pay refunds of collected state income taxes that were held to have been illegally collected, or have imposed procedural limitations on such refunds that make it nearly impossible to recover the overpaid taxes.

Application of FAS 5 to Income Taxes. FIN 48 makes clear that FAS 5 no longer has any application to loss contingencies related to income taxes.[14] The resulting differing treatment of contingencies related to income taxes as compared to contingencies related to other types of liabilities is difficult to justify and will likely lead to confusion. The Board's reasoning for carving out income taxes for special treatment is unconvincing.[15]

The Board's decision on the treatment of contingencies related to income taxes raises the question whether the approach to uncertainties in FIN 48 might be applied more broadly to other contingent liabilities, such as litigation or environmental liabilities. The Board has a project open on assets and liabilities with uncertainties (FAS 5) generally, as does the International Accounting Standards Board.[16] However, it appears that the Board views tax disputes as unique and would not apply the guidance in FIN 48 to other types of contingencies (with the possible exception of contingencies related to self-assessed non-income taxes and other similar self-assessed liabilities).[17]

Recognition

FIN 48 applies a two-step process to determine the amount of tax benefit to be recognized in the financial statements. The first step is recognition, which determines as a threshold matter whether *any* amount of the tax benefit may be recognized. The second step is measurement, which applies only to tax positions that qualify for recognition, and determines *how much* of the tax benefit should be recognized.

Recognition in General. The tax benefit of a tax position qualifies for recognition in the financial statements when it is more likely than not (a likelihood of more than 50 percent), based on the technical merits, that the position will be sustained upon examination (including resolution of any administrative or judicial appeals). Each tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions.[18]

The more-likely-than-not initial recognition standard adopted in FIN 48 is a retreat from the highly criticized ''probable'' recognition standard that was pro-

[14] FIN 48, ¶ C2.
[15] See discussion below regarding audit detection.
[16] *See* http://www.fasb.org/draft/itc_assets_liabilities_with_uncertainties.pdf.
[17] *See* FIN 48, ¶ B64.
[18] This limitation is apparently intended to limit an entity's ability to offset or aggregate low probability tax items with high-probability tax items. Since ''trading issues'' is common in the resolution of many tax controversies, this limitation could unreasonably overstate a taxpayer's tax liability.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

posed in the Exposure Draft[19] that preceded the adoption of FIN 48. While this relaxation of the recognition threshold substantially mitigates some of the irrational financial reporting results that would have flowed from the approach in the Exposure Draft, FIN 48 still unreasonably implies that zero benefit will be recognized in all cases in which an entity is unable to demonstrate a greater than 50 percent likelihood of sustaining a position on the merits. In reality, there will likely be situations in which an entity is confident that some significant portion of the tax benefit of a position will be sustained as a legal or practical matter, but zero benefit will be reflected in the financial statements because of the artificial presumption against recognition under FIN 48's initial recognition standard.

Audit Detection. In assessing whether a tax position meets the initial recognition threshold, the entity must presume that the tax position will be examined by the relevant taxing authority and that the tax authority has ''full knowledge of all relevant information.''[20] The board justifies this presumption on the ground that taxes are required to be self-assessed and are subject to post-filing examination.

The justification for the presumption of audit detection is unconvincing, and the presumption is a particularly troublesome aspect of FIN 48.

The justification for the presumption of audit detection is unconvincing,[21] and the presumption is a particularly troublesome aspect of FIN 48. It requires entities to accrue liabilities and related penalties and continuing interest (potentially forever) even where there is no realistic possibility that any amount will ever be paid. For example, assume the tax position is that the entity is not subject to tax in a particular jurisdiction because it does not have tax ''nexus'' in that jurisdiction. However, due to ambiguities in the laws regarding what level of activities may give rise to tax nexus for income tax purposes, the entity is unable to establish that it is more likely than not that it would prevail on the merits if the relevant tax authority were to assert that the entity had tax nexus and should have filed income tax returns and paid tax for prior periods. There is generally no period of limitations for assessment of tax on the entity. Accordingly, even if it is highly unlikely as a practical matter that the tax authority would ever assert a tax deficiency, under the approach of FIN 48, the entity would appear to be required to accrue the tax and applicable interest and penalties literally forever.[22]

Comment letters raised the concern that the presumption of audit detection could lead to perpetual liabilities. Apparently, the administrative practices and procedures exception (discussed below) is intended to address those concerns. How-

[19] FASB Proposed Interpretation—*Accounting for Uncertain Tax Positions, an Interpretation of FASB Statement No. 109*, File Ref. No. 1215-001 (July 14, 2005) (hereinafter, the ''Exposure Draft'').

[20] FIN 48, ¶ 7(a).

[21] *See* Browne, *above* n. 2, at p. 88. Most obviously, there are numerous other types of liabilities and loss contingencies that are initially determined by the contingently liable party and are subject to examination by the counterparty (including sales and other non-income taxes, certain environmental liabilities, certain pension liabilities, etc.). Loss contingencies associated with these liabilities remain subject to the ''probable of assertion'' standard of FAS 5, and no explanation is given for the uniquely contrary treatment imposed on loss contingencies related to income tax liabilities.

[22] Such ''perpetual'' liabilities can arise in contexts other than nexus issues. *See, e.g.,* Tex. Code Ann. § 111.205(a)(3) (no period of limitations on assessment of tax underpayment of 25 percent or more).

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

ever, that exception is of such limited application that it will not alleviate the concerns that were expressed to the Board.[23]

Administrative Practices and Precedents. For purposes of FIN 48, the technical merits of a tax position are generally based solely on established legal authorities (statutes, legislative history, regulations, administrative rulings, and judicial precedents). However, administrative practices and precedents can be taken into account in some circumstances.

> When the past administrative practices and precedents of the taxing authority in its dealings with the enterprise or similar enterprises are widely understood, those practices and precedents shall be taken into account.

The illustrative guidance in Appendix A of FIN 48 indicates that this exception would apply to (i) a position that capital expenditures below a minimum amount may be immediately deducted, and (ii) a position that an entity is not subject to tax in a given state for periods prior to the time it started filing tax returns in that state.[24] The background information in Appendix B of FIN 48 further indicates that this exception is intended to have narrow application. It does not override the general requirement to presume that all tax positions will be examined and that the tax authority will have the same information regarding the tax position that is available to the entity. It is intended to apply only in ''those limited circumstances in which taxing authorities permit what might be deemed technical violations of the tax law.''[25]

Unit of Account. A significant issue under FIN 48 is determining the applicable tax position to be analyzed for initial recognition. If the applicable tax position is broadly defined, and the entity is unable to establish that all elements of the tax position will likely be sustained, the entity could potentially be unable to recognize any tax benefit for the position. For example, if the total amount of the R&E tax credit claimed on a tax return is the applicable tax position, and if an entity is unable to establish that the entire amount of the claimed tax credit will likely be sustained, the entity might be required to reserve the entire tax credit, even if it is clear that there is little risk of disallowance as to a significant majority of the reported credit. To mitigate this irrational zero benefit effect, FIN 48 allows tax items on a return to be analyzed at a lower level of detail in appropriate circumstances.

FIN 48 does a good job of clarifying the determination of the unit of account concept, and provides a reasonable approach to determining the level at which tax positions should be analyzed, consistent with common practice under existing GAAP.

The determination of the applicable tax position to be analyzed is based on the ''appropriate unit of account.'' The determination of the appropriate unit of account ''is a matter of judgment based on the individual facts and circumstances

[23] An example in Appendix A of FIN 48 allows an entity to ignore its potential liability for unpaid taxes for periods prior to when it began filing tax returns (20 years prior) where the entity's ''understanding'' is that the tax authority will look back only six years. It is unlikely that any state would be willing to concede that it will not look back beyond six years or any other predetermined period, particularly if the tax authority is deemed to have ''full knowledge or all relevant information'' regarding the entity's unpaid taxes for prior periods. Therefore it may be difficult in more typical circumstances (where returns have never been filed) to avoid a perpetual liability accrual.

[24] FIN 48, ¶¶ A12-A15.

[25] FIN 48, ¶¶ B35-B37.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

of that position evaluated in light of all available evidence'' and should ''consider the manner in which the enterprise prepares and supports its income tax return and the approach the enterprise anticipates the taxing authority will take during an examination.''[26]

FIN 48 does a good job of clarifying the determination of the unit of account concept, and provides a reasonable approach to determining the level at which tax positions should be analyzed, consistent with common practice under existing GAAP. Nevertheless, the subjective nature of the unit of account determination may generate confusion and inconsistency in application, contrary to the stated goals of FIN 48.

Valuation Versus Validity. The Exposure Draft contained an example that suggested a further mitigation of the harsh zero benefit effect of the initial recognition standard. The example involved a donation of intangible property to a charitable organization and the issue of whether the entity's valuation of the property for purposes of calculating its charitable contribution deduction would be sustained on examination. The entity estimated that only 60 percent of the claimed deduction would be sustained. On these facts, one might have concluded that the deduction failed to qualify for initial recognition because it was unlikely that the reported deduction would be sustained if the matter were litigated. Surprisingly, the entity in the example was allowed to record a tax benefit in its financial statements for the 60 percent estimated settlement amount on the theory it was clear that the donation gave rise to a valid deduction under the tax law, and the only issue was the *amount* of the deduction to be allowed.

This example is not included in FIN 48, and the numerous references in the Exposure Draft to the validity of a tax position are eliminated in FIN 48. Nevertheless, it appears that this remains a legitimate distinction in applying FIN 48. It might have particular application in the transfer pricing area,[27] where the availability of a deduction in some amount may be clear, but it is difficult to establish that it is more likely than not that the full amount claimed by the entity will be sustained.[28]

The somewhat nebulous distinction between the timing of a tax benefit versus the validity of the underlying tax position creates the potential for some anomalous results.

Timing Versus Validity. FIN 48 includes an example that draws a distinction between the timing of a deduction versus its validity.[29] The example involves an entity that claims an immediate deduction for a $15 million expenditure in circumstances where the more likely outcome is that the expenditure must be capitalized and amortized over 15 years. One might have thought that the $15 million deduction did not qualify for initial recognition because the tax position that the expenditure is deductible is not likely to be sustained. However, FIN 48 concludes that there is no uncertainty regarding the validity of the $15 million de-

[26] FIN 48, ¶ 5.

[27] *See* I.R.C. § 482, and corresponding provisions of other tax laws.

[28] Although the valuation versus validity distinction may be useful in satisfying the initial recognition requirement, the measurement standard could still prevent recognition of any tax benefit in circumstances where the level of uncertainty is so high that no reasonable estimate of the probability of any particular outcome can be made. See the discussion of the measurement standard below.

[29] FIN 48, ¶ A26-A27.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

duction and that only the timing of the deduction is uncertain. The example applies a probability weighted expected outcome analysis to measure the amount of tax benefit to be recognized. Although the example concludes that $1 million amortization is the largest tax benefit with a greater than 50 percent likelihood of being realized, the example leaves open the possibility that in other circumstances an entity might be able to establish that a larger amount of tax benefit has a greater than 50 percent likelihood of being realized (e.g., if the case is likely to be settled on the basis of 3-year or 5-year amortization, or settled on the basis of only a portion of the deduction being capitalized). This type of intermediate settlement analysis would not be allowable if the initial recognition analysis focused solely on whether the return position would be sustained and not on the timing of when the tax benefit would be realized.

The somewhat nebulous distinction between the timing of a tax benefit versus the validity of the underlying tax position creates the potential for some anomalous results. What if the IRS asserted that the expenditure in the example were not amortizable (e.g., should be capitalized into the cost basis of stock not held for disposition)? In that case, the deduction would apparently not qualify for initial recognition (unless it is more likely than not that the deduction will be sustained), and the entity could not consider potential settlement outcomes. So even if the entity had a high level of confidence that it could settle the case based on capitalizing only 40 percent of the expenditure, it could recognize no benefit for the position. In contrast, if the expenditure qualified for amortization, the entity could recognize the expected settlement benefit. It is not clear why these similar factual scenarios should lead to such dramatically different results, or how this improves financial reporting. Compare the situation under existing GAAP, which allows the entity in both cases to reasonably estimate the expected outcome.

Amount to Be ''Not Recognized.'' FIN 48 gives no guidance on how to determine the amount of tax benefit to be ''not recognized'' when the initial recognition threshold is not satisfied. The amount to be not recognized will not be obvious in all cases. For example, assume an entity takes the position that a transaction does not give rise to taxable income, but it cannot satisfy the requirements for initial recognition of the tax benefit of that position. The entity may be unable to reasonably estimate the amount of income the tax authority is likely to assert that the entity should have reported with respect to the transaction. It is unclear what amount of tax benefit should be not recognized in this fairly common situation.

Accounting for Positions Not Recognized. When a reported tax position is not recognized in the financial statements, the entity must restate its current and deferred tax accounts to conform to the treatment of the tax items as recognized for financial reporting purposes.[30] The effect is that an entity's FAS 109 calculations will be based on the differences between the book basis of assets and liabilities and the hypothetical tax basis of those assets and liabilities as deter-

[30] *See* FIN 48, ¶ A27.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

mined in accordance with FIN 48. The audit trail from the FAS 109 tax accounts to the tax returns will be broken, creating potential for significant confusion. For example, an entity may have a significant net operating loss carryforward for tax purposes that is being utilized in current periods to avoid payment of current taxes. However, if the net operating loss carryforward does not qualify for recognition under FIN 48, the financial statements will not reflect any deferred tax asset for the carryforward, which may cause users of the financial statements to wonder why the entity is not paying cash taxes on its earnings.

Evidentiary Requirements. The Exposure Draft contained a non-exclusive list of types of evidence that would demonstrate satisfaction of the requirements for initial recognition, including: unambiguous tax law, an ''unqualified'' tax opinion for which all conditions are objectively verifiable, prior examination results of similar positions, and litigation results of other taxpayers involving similar positions. The list of the types of evidence that would be sufficient to meet the recognition standard raised more questions than it answered, and those references were dropped in the final interpretation. The background information in Appendix B makes clear that a tax opinion is not necessary, and that the level of evidence required ''is a matter of judgment that depends on all available information.''[31]

Measurement

Paragraph 8 of FIN 48 provides:

> A tax position that meets the more-likely-than-not recognition threshold shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.

FIN 48 contemplates that routine tax positions involving clear and unambiguous legal authority will be fully recognized in the financial statements without significant analysis.[32] For tax positions involving a 50 percent or less likelihood of being sustained in full, FIN 48 generally contemplates that the entity will construct a table of probability weighted estimated outcomes. For example, if an entity claims a deduction that produces a $100 tax benefit, the probability weighted table of expected outcomes might look like this:

Possible Estimated Outcomes ($)	Individual Probability of Occurring (%)	Cumulative Probability of Occurring (%)
100	5	5
80	25	30
60	25	55
50	20	75
40	10	85
20	10	95
0	5	100

[31] FIN 48, ¶ B34.
[32] FIN 48, ¶ A20.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

The table indicates that there is only a 5 percent chance that the reported deduction will be sustained in full, a 30 percent chance that a deduction of at least $80 will be sustained, a 55 percent chance that a deduction of at least $60 will be sustained, and so on. The entity should record a tax benefit of $60, the largest amount of benefit that has a greater than 50 percent likelihood of being sustained upon ultimate settlement.[33]

A table of probability weighted expected outcomes is not required when the entity has a high confidence level that a particular outcome will be sustained and little information regarding other possible outcomes (for example when a tax position is similar to another position that has recently been agreed with the taxing authority and the prior agreement is expected to be applied to the tax position).[34]

"Nuisance" Settlements. Arguably, even where an entity has a very high level of confidence that a tax position will be fully sustained if the matter is litigated, the entity might settle the matter for less than 100 percent of the claimed benefit simply to avoid the costs and disruptions associated with litigating the case. Does FIN 48 require that all tax positions be discounted to reflect settlement tolerances (as was suggested by some of the Board discussions on the Exposure Draft)?

The answer should be no. Entities should not be required to discount tax benefits to account for settlement tolerances where the strength of the entity's position suggests that the tax authority would concede the issue rather than litigate it.

Is FIN 48 a High End of the Range Standard? FIN 48's measurement standard unrealistically assumes that tax controversies can be analyzed with statistical precision, and that a finite number of discrete outcomes can be identified and assigned specific probabilities of occurrence. This will rarely be the case. More commonly, a particular tax issue may have several alternative theories in dispute, a multitude of potential outcomes within a range of potential outcomes under one or more theories, and in some cases no known range of potential outcomes (e.g., because the tax authority has not stated its position on the issue). Even where there are a finite number of discrete outcomes, assigning a particular level of probability to any such outcome may be impossible.[35] As a result, it is unclear how the new measurement standard of FIN 48 is to be applied in practice.

It seems that in the relatively common case where it is impossible to assign specific probabilities to specific potential outcomes of a tax dispute, the measurement standard of FIN 48 will effectively act as a "high end of the range" convention.

To illustrate, assume an entity claims an immediate deduction for a $300 payment associated with the acquisition of the assets of a business. On audit, the tax

[33] FIN 48, ¶ A22. Note that if there was a 45 percent probability of sustaining $50 and no probability of sustaining any lesser benefit, $50 would be the most likely outcome (highest individual probability of occurring), but would not be the amount recognized. FIN 48, ¶¶ A23-A24.

[34] FIN 48, ¶ A25.

[35] *See, e.g.,* American Bar Association, *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (Mar. 2003) ("Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises.").

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

authority asserts that the payment must be capitalized and amortized over 15 years under I.R.C. § 197. The entity has offered to resolve the matter by capitalizing $100 of the $300 payment, but the tax authority will resolve the matter only if $200 of the payment is capitalized. The entity's position is that it would rather litigate the case than concede two-thirds of the tax benefit. It is impossible to predict the ultimate outcome of settlement discussions or of any judicial resolution of the case.

On these facts, the entity would meet the requirements for initial recognition of the tax benefit because it is certain that a deduction will be allowed, and only the timing of the deduction is in dispute.[36] The question is measurement. Under one theory, the entity might recognize 1/3 of the tax benefit because there is a 100 percent probability of being able to resolve the matter for that amount, and no probability can be assigned to any greater amount. However, if the entity is truly unwilling to settle the case on that basis, it could be argued that the entity cannot recognize any tax benefit because the entity is unable to establish the probability of any potential outcome in excess of $0.

It seems that in the relatively common case where it is impossible to assign specific probabilities to specific potential outcomes of a tax dispute, the measurement standard of FIN 48 will effectively act as a ''high end of the range'' convention. It will also apparently force entities to estimate the high end of the range (or the maximum concession necessary to be certain a resolution can be achieved) even when it has no information regarding the tax authority's intended deficiency assessment or litigating position. It is unclear how this is an improvement to existing GAAP. There does not appear to be any other instance under GAAP in which an entity must accrue a liability that cannot be reasonably estimated.[37] FIN 48 will therefore likely create confusion, complexity, and inconsistency, contrary to the Board's claims to the contrary.

Will FIN 48 Influence the Outcome of Disputes? It is not uncommon for the IRS and other tax authorities to propose grossly overstated tax deficiencies.[38] Once proposed, the deficiency may have a presumption of correctness and the

[36] FIN 48, ¶ A26-A27.

[37] Recent ''fair value'' accounting standards impose no requirement to recognize a liability that cannot be reasonably estimated. *See, e.g.,* FASB Statement No. 143, *Accounting for Asset Retirement Obligations* (''This Statement requires that all asset retirement obligations . . . be recognized when a reasonable estimate of fair value can be made.''); FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (Mar. 2005) ¶ B19 (''The Board decided that an entity should measure and recognize the fair value of an asset retirement obligation when enough information is available to develop assumptions about the potential timing and amounts of cash flows''); IASB, *Exposure Draft of Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits* (June 2005), ¶ 28 (''In the extremely rare case in which an entity cannot measure reliably a non-financial liability, the liability does not qualify for recognition in accordance with this [draft] Standard.''); GASB, *Proposed Statement: Accounting and Financial Reporting for Pollution Remediation Obligations* (Jan. 31, 2006), ¶ 10 (''Pollution remediation liabilities should be recognized as the ranges of their components become reasonably estimable. . . .''). FIN 48's absolute requirement to recognize and measure a liability that cannot be reasonably estimated is an inexplicable departure from established precedent. *See also* FASB Statement No. 157, *Fair Value Measurements*, ¶ C21 (Sept. 18, 2006) (continuing ''practicality exceptions'' to fair value measurements in circumstances where fair value is not reasonably determinable or cannot be measured with sufficient reliability).

[38] *See generally DHL Corp. v. Commissioner*, 285 F.3d 1210 (9th Cir. 2002) and cases cited therein discussing grossly inflated proposed transfer pricing deficiencies that were later abandoned at trial. The IRS has proposed an eye-popping $14.5 billion deficiency against GlaxoSmithKline, which the company resolved for $3.1

 COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

affected entity may bear a heavy burden in proving that the deficiency is incorrect. Moreover, the entity's administrative or judicial remedies may be limited as a legal or practical matter.[39] As a result, an entity may be forced under FIN 48 to fully reserve the proposed deficiency. In some cases, the collateral impacts of such an accrual could be so devastating that the entity has no choice but to compromise the matter on a basis that does not fairly represent the merits of its position. In this respect, FIN 48 could influence the actions and effective legal rights of the entity.

Practical Application. Because an entity will rarely be able to estimate the probability of any particular outcome of a tax dispute with statistical precision, it appears that FIN 48 will have to be applied leniently. It seems likely that, in practice, entities will estimate the probability of outcomes not based on strict statistical analysis but based on subjective judgment and practical realities, and that financial auditors will assess those judgments based on reasonableness and not based on traditional notions of statistical theory and methodology. Thus, while FIN 48 professes to achieve consistency in financial reporting through objective standards, it is unlikely that it will eliminate the subjectivity inherent in evaluating legal disputes. FIN 48 will merely ensure that tax liabilities are measured closer to the highest potential amount than to the lowest potential amount.

Other Technical Matters

Tax Planning Strategies. Under paragraph 21(d) of FAS 109, entities are allowed to take into account certain tax planning strategies in determining the amount of available future taxable income to realize a tax benefit for an existing deductible temporary difference or carryforward. FIN 48 makes clear that the recognition and measurement criteria of FIN 48 apply in determining the amount of future taxable income. As a result, only a tax-planning strategy that meets the more-likely-than-not recognition threshold would be considered in evaluating the sufficiency of future taxable income for realization of deferred tax assets.

This approach is sensible in that it harmonizes the standard for recognizing the effects of tax planning strategies with the standard for determining valuation allowances. It should not have any significant effect on existing practice under the current rules.[40]

Subsequent Changes. Tax benefits initially not recognized under the initial recognition standard will be recognized in a subsequent period if the recognition requirement is subsequently satisfied (e.g., through changes in facts or legal precedents, settlement, or expiration of the period of limitations). Likewise, a tax

---

billion. *See Daily Tax Report* (BNA), No. 177, p. G-16 (Sept. 13, 2006)(as corrected). The practice of issuing inflated deficiency notices is not limited to the IRS. Last year MCI settled $2 billion in proposed state tax deficiencies for approximately $120 million. *MCI, Inc.*, SEC Form 10-Q (Nov. 3, 2005), at p. 25.

[39] For example, the competent authority procedures for resolving multinational transfer pricing disputes often do not result in any resolution of the dispute.

[40] Under current rules, a tax planning strategy must be one that is prudent and that management intends to implement. A strategy having a less than 50 percent chance of being sustained would rarely meet that requirement. Moreover, even if the entity would implement such a strategy, the benefits likely would be fully reserved on the assumption that it is probable that the benefits would be disallowed on audit.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

position previously recognized must be ''derecognized'' when the position no longer satisfies the initial recognition standard. For recognized tax positions, the measurement of the tax benefit that will be sustained must be reevaluated at each reporting date to determine if changes in the probable settlement amount are warranted based on changes in facts, circumstances, or information available at the reporting date. Subsequent changes in judgment that lead to changes in recognition, derecognition, and measurement should result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.

This guidance provides useful information on when tax reserves should and should not be adjusted. It confirms the practice of most entities whereby changes are made when and only when material and new, typically external, information clearly justifies a material change in the estimated loss contingency amount (for example, closing of the tax years under audit, a binding settlement of an audit, a significant final judicial decision in the case or in a case involving a substantively identical issue).

Interim Period Adjustments. An issue under existing GAAP is whether a change in tax reserves that were recorded in a prior annual period should be accounted for as part of the effective tax rate for the annual period in which the change is made (the ''integral method''), or as a discrete item in the interim period in which the change is made (the ''discrete method''). FIN 48 resolves any uncertainty on this issue by requiring use of the discrete method.

Interest and Penalties—Recognition and Measurement. A liability for tax deficiency interest must be accrued through expense in the periods in which the interest would accrue under the relevant tax law. The interest is computed on the difference between the tax benefit recognized (or expected to be recognized) in the tax return and the tax benefit recognized in the financial statements.[41] Thus, if a $100 reported tax benefit does not meet the more-likely-than-not requirement for financial statement recognition, the entity must assume that the benefit will be disallowed in full on audit and must accrue interest on the resulting $100 deficiency. If 70 percent of the tax benefit is recognized, then interest on the 30 percent implicitly expected to be disallowed must be accrued.

If a tax position does not meet the minimum statutory threshold for avoidance of a penalty, a liability for the penalty must be accrued through expense for the period in the period in which the entity ''claims or expects to claim the position in the tax return.''[42] In the case of a penalty for underpayment of taxes, it appears that the penalty must be recognized in the period in which the tax benefit is ''not recognized'' for financial reporting purposes, and not in the period in which the formal act giving rise to the penalty occurs. For example, if an expenditure is made in the second quarter of the year and the entity expects to take the

[41] FIN 48, ¶ 15.
[42] FIN 48, ¶ 16.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

position that the expenditure is deductible, any penalty applicable to the disallowance of that position would be recognized in the second quarter, even though the penalty only applies when the tax return for the year is filed. Again, the penalty is based on the difference between the tax benefit reported on the tax return and the benefit recognized in the financial statements.

Interest and Penalties—Classification. Under existing GAAP, it is unclear whether interest and penalties accrued with respect to loss contingencies related to income taxes should be included as part of income tax expense, or should instead be treated as part of interest expense (in the case of tax deficiency interest) or other expense (in the case of penalties). There was significant diversity in practice on this matter, and an entity's policy on classification of interest and penalties related to taxes was rarely disclosed in the financial statement footnotes. During the deliberations on the Exposure Draft, the Board considered whether it should mandate a particular classification, but ultimately decided to leave the issue to the discretion of the entity. FIN 48 states that interest on unrecognized tax benefits may be classified either as components of income tax expense or as interest expense. Similarly, penalties may be classified either as components of income tax expense or as another appropriate expense classification. The classification must be consistently applied,[43] and the entity's policy on classification must be disclosed in the footnotes.[44]

Classification of Unrecognized Tax Benefit. Under existing GAAP, practice has varied regarding the classification of tax reserves as either a current liability or a non-current liability, and in some cases tax reserves have been improperly classified as deferred tax liabilities or as valuation allowances. FIN 48 makes clear that a liability for a potential tax deficiency should be classified as a current liability only if it is expected to be paid within one year (or the current operating cycle, if longer), and that the liability should not be combined with deferred tax liabilities or assets, or reported as part of a valuation allowance.[45]

Note that an unrecognized tax benefit can require changes to deferred tax assets and liabilities or valuation allowances. For example, if the tax benefit of a current deduction is not recognized because the deduction is likely to be capitalized and amortized, the amount deemed capitalized will create a deferred tax asset or reduce a deferred tax liability (depending on whether there is an associated book asset). The effect is that after FIN 48, deferred tax accounting will be based on a hypothetical tax return rather than being based on the actual tax returns. As previously discussed, this disconnect will create significant problems and confusion without any apparent benefits to users of the financial statements.

---

[43] In addition to being consistent between reporting periods, it is implicit that the classification should be consistent between the income statement and the balance sheet. So if tax deficiency interest is treated as a component of tax expense in the income statement, the accrued liability for tax deficiency interest would be reported as part of accrued tax liability on a net of tax basis, whereas if tax deficiency interest is treated as a component of interest expense, the accrued liability should be included in accrued interest expense on a pre-tax basis.

[44] FIN 48, ¶¶ 19, 20.

[45] FIN 48, ¶ 17.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

Disclosure

FIN 48 seeks to codify and significantly expand existing disclosure requirements related to tax loss contingencies. It makes clear that estimated tax loss contingencies are covered by AICPA Statement of Position 94-6, *Disclosure of Significant Risks and Uncertainties*, which deals with ''risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity.''[46] FIN 48 also requires a new tabular reconciliation of the amounts of unrecognized tax benefits at the beginning and end of the period, and certain other new disclosures. Specifically, the new disclosure requirements for unrecognized tax benefits are as follows:

a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:

(1) the gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period,

(2) the gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period,

(3) the amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities, and

(4) reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

c. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position.[47]

d. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:

(1) the nature of the uncertainty,

(2) the nature of the event that could occur in the next 12 months that would cause the change, and

[46] SOP 94-6 requires supplemental disclosures when it is at least reasonably possible that an estimate will change materially in the near term. The supplemental disclosures must indicate the nature of the uncertainty, that a change is reasonably possible, and, if the estimate involves a loss contingency, include an estimate of the possible loss or range of loss (or state that such an estimate cannot be made).

[47] The tabular reconciliation required under the new rules will look like the following:

Beginning balance of unrecognized tax positions
+ increases as a result of current period positions
- decreases as a result of current period positions
+ increases as a result of prior period positions
- decreases as a result of prior period positions
- decreases related to settlements
- decreases as a result of statute expirations
= ending balance of unrecognized tax positions

 COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

(3) an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.

e. A description of tax years that remain subject to examination by major tax jurisdictions.

The "Roadmap" Concern. Several constituents expressed concern that the footnote disclosures required by FIN 48 will provide a roadmap for tax authorities to the audit issues in an entity's tax returns. The Board correctly concluded that the aggregated disclosure information would rarely reveal information on specific audit issues, and that other information required in the tax returns were likely to provide more relevant information for the tax authorities. Nevertheless, there is a significant roadmap concern associated with all of the documentation that the entity will be required to generate and maintain to support the aggregated information and to support the determinations required under the recognition and measurement standards.

Estimate of Near Term "Changes." One confusing aspect of the new disclosure requirements is the requirement to specifically and separately disclose the estimated amount of material changes that are expected within the next 12 months. Does this mean that, if the statute of limitations on a tax year will close on 12/31/2007, the entity must disclose in its first quarter 2007 financial statements the amount and nature of any tax reserves that it expects to release at year end as a result of the statute expiration? That disclosure itself could invalidate the estimate because it would signal to the affected tax authority the amount of reported tax benefits that do not meet the recognition threshold, and trigger an assessment.[48] Moreover, if the entity must assume audit detection, is it ever reasonably possible that an unrecognized tax benefit will be recognized as a result of a statute lapsing?[49] While FIN 48 doesn't address these issues, it seems that, consistent with the presumption of audit detection, the entity could appropriately defer disclosure of estimated future reserve releases until the risk of assessment is legally foreclosed by actual lapsing of the statute of limitations or other means. Alternatively, the entity might note the fact that the statute is expiring at 12/31/07 and state that it is not possible to estimate the effect on the entity's unrecognized tax benefits.

EFFECTIVE DATE AND TRANSITION

As noted above, FIN 48 is effective for fiscal years beginning after December 15, 2006, and will be accounted for as a change in accounting principle. For calendar year entities, that means that the entity must report the cumulative effect of the adoption of FIN 48 in the opening balance of retained earnings as of January 1, 2007 in the interim financial statements issued after that date (i.e., first quarter 2007). Earlier adoption is not permitted unless the enterprise has not

[48] This issue is apparently avoided under SOP 94-6 because it requires an estimate only as to "possible loss or range of loss," which would not appear to include gains from reductions in loss contingency accruals.

[49] In contrast, if a decision is expected during the current year in a matter in litigation, it may be appropriate to disclose the potential effects of that decision.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

yet issued financial statements (including interim statements) in the period of adoption).

In accordance with SEC Staff Accounting Bulletin 74 (''SAB 74''), SEC registrants will be required to include in their filings after July 14, 2006, and before adoption of FIN 48 a disclosure that FIN 48 has been adopted and a discussion of the potential effects (including collateral effects) of the adoption of FIN 48 on the registrant if those effects are expected to be material. If the potential effects are not known or reasonably estimable, a statement to that effect is sufficient.

CONCLUSION

The Board asserts that FIN 48 will improve financial reporting for uncertain tax positions because all such positions will be accounted for using consistent criteria. Admittedly, FIN 48 provides useful guidance on some technical matters (subsequent adjustments, interim period accounting, and classification), and generally provides meaningful requirements for footnote disclosures. However, it will not improve financial reporting for income taxes overall. The new criteria for recognition and measurement of tax benefits (including the unrealistic mandatory presumption of audit detection) will force companies to overstate their tax liabilities, add significant complexity to the reconciliation of book and tax differences, create confusion regarding the differing standards for income tax contingencies versus other similar contingencies (including contingencies related to non-income taxes), and potentially cause financial reporting effects to influence rather than faithfully reflect an entity's exercise of its substantive legal rights.

The shortcomings of FIN 48 could have been easily avoided through clarification and reinforcement of existing GAAP, or through some intermediate approach consistent with the treatment of other assets and liabilities with uncertainties. The Board apparently felt that the potential for understatement of tax liabilities under existing GAAP was so intolerable that the existing rules should be abandoned, regardless of any adverse collateral effects. The only hope now is that the IASB adopts a more sensible approach that can ultimately be adopted to replace FIN 48.

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.

NEW!
ASK ABOUT
OUR CHARTER OFFER!

Accounting Policy & Practice Series

Detailed Analysis, Examples, News.

Others reiterate accounting rules.

We interpret them.

Looking for plain-English guidance to help you better understand and apply accounting rules and standards? Turn to the new **Accounting Policy and Practice Series** from BNA, the publisher that set the industry standard for tax analysis.

- **Know what the rules *mean* and how to *apply* them**. This portfolios-based resource—available electronically and in print—offers detailed, practical guidance, illustrative examples and sample journal entries so you know precisely what the rules mean and how to apply them.
- **Know your options**. Portfolios outline multiple options and provide author perspectives so you can make the most informed accounting policy decisions.
- **Know what's happening** with *Accounting Policy and Practice Report*, offering ongoing interpretations of the latest accounting rules and pronouncements, and interviews with industry leaders and policymakers.

See for yourself the difference **Accounting Policy and Practice Series** can make. Take a **FREE** 15-day trial by calling your BNA representative at 1.800.372.1033.

www.bnatax.com

COPYRIGHT © BY THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C.