An Analysis of Disclosures Under FIN 48

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ABSTRACT

The FASB issued Interpretation No. 48 in an effort to clarify accounting for income taxes, specifically addressing accounting for uncertainty in income taxes. This Interpretation adopts a two-step process – recognition and measurement. Tax positions are to be recognized if they meet the more likely than not threshold. Measurement of the benefit is the largest amount of tax benefit that is greater than fifty percent likely of being realized upon settlement. The interpretation provides standards for subsequent recognition, derecognition, and changes in measurement. The most controversial area of FIN 48 is the required disclosures, most notably the disclosures of unrecognized tax benefits. This paper examines those disclosures and their implications for enterprises making the disclosures. In addition, the impact of the apparent erosion of the IRS Policy of Restraint is examined.

INTRODUCTION

In June 2006, the Financial Accounting Standards Board (FASB) released FASB Interpretation 48 (FIN 48). This Interpretation is effective for fiscal years beginning after December 15, 2006. The title of the interpretation is "Accounting for Uncertainty in Income Taxes," and is an interpretation of FASB Statement No. 109. There are three objectives that FIN 48 seeks to accomplish:

- Clarify accounting for income taxes
- Provide greater consistency in criteria used to recognize, derecognize, and measure benefits related to income taxes.
- Establish consistent thresholds, improving relevance and comparability of financial statement reporting. [7]

SFAS No. 109

As mentioned, FIN 48 is an interpretation of FASB Statement No. 109. The Statement of Financial Accounting Standards No. 109 was effective for fiscal years beginning after December 15, 1992. It replaced the Statement of Financial Accounting Standards No. 96. As the focus of this paper is not SFAS No. 109, only a brief overview is given here. The objectives of SFAS No. 109 are to recognize:

- The amount of taxes payable or refundable current year, and
- Deferred tax liabilities and assets for the future consequences of events that have been recognized in an enterprise's financial statements or tax returns. [8]

Although SFAS No. 109 provided a great deal of guidance in accounting for income taxes, one of its important features is that it established four basic principles of accounting for income taxes.

- A current liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.

- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
- The measurement of current and deferred tax liabilities and assets is based on provisions of enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred taxes is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized. [8]

Even though SFAS No. 109 provided more guidance than had previously been available, its focus was on deferred tax liabilities and assets. Little guidance was given for how to account for uncertain tax positions. As a result, there arose a variety of inconsistent accounting practices in the reporting of tax positions. FIN 48 is an attempt to introduce some uniformity and comparability in the reporting of income taxes as reported on financial statements. [21]

FIN No. 48 – A TWO-STEP PROCESS

FIN 48 defines a tax position as "a position taken in a previously filed return or a position expected to be taken in a future return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods." [9] The interpretation continues, explaining that a tax position can be a permanent reduction of income taxes payable, a deferral of taxes payable, or a change in the realizability of deferred tax assets. A tax position can be a decision not to file a return, an allocation of income between jurisdictions, the characterization of income or a decision to exclude reporting taxable income in a tax return, or a decision to classify a transaction, entity, or other position in a tax return as tax exempt. [9]

As can be seen, the definition of a tax position is quite broad, and can impact a large number of enterprises including tax-paying, pass through, and exempt entities. For example, a 501(c)(3) entity may make the determination that a certain type of its income is not unrelated business taxable income (UBTI). This is a tax position, and if the income is of a type that puts it into the gray area, the enterprise has an uncertain tax position.

To accomplish its objectives, FIN 48 lays out a two-step process, first establishing a recognition threshold, then following with measurement criteria. The Interpretation adopts a standard of "more likely than not (MLTN)" as the threshold for recognizing an uncertain tax benefit. More likely than not is considered a "positive assertion of entitlement to the economic benefits of the positions. Furthermore, it is presumed that the position will be upheld by relevant tax authority having full knowledge of all relevant information. [9] Obviously, this precludes the enterprise from withholding damaging information if the tax position is examined by the appropriate taxing authority.

Critical to the recognition threshold is the adoption of a "unit of account." The FASB declined to define a unit of account, but stated that it should be based on individual facts and circumstances in light of all available evidence. [9] In determining the unit of account the enterprise should consider both the level at which the entity accumulates information to support the tax return as well as the level at which it expects tax authorities to address the issues during an examination. [1] For example, the company may report tax depreciation expense by project or aggregated on all of its projects.

The definition of the unit of account adopted by the enterprise should be undertaken with a great deal of care, as that definition must be maintained for future periods unless there is a change in the "facts and circumstances" to warrant a change in the unit of account. [21] In a FIN 48 Client Action Plan, PriceWaterhouseCoopers suggests that management document its judgment and provide a basis for its conclusions on unit of account in cases where significant judgment is required. [18]

Once the enterprise determines that it must recognize an uncertain tax position, management must then turn to the task of measuring the position. The amount of tax benefit to be recognized is "the largest amount of tax benefit that is greater than 50 percent likely of being realized upon effective settlement with a taxing authority that has full knowledge of all relevant information. [9]

Initially, the Interpretation used the terminology "ultimate settlement." However, in FASB Staff Position No. FIN 48-1, the Interpretation was effectively amended with a substitution of effective settlement in lieu of ultimate settlement. In an explanation, the paper stated that settlement is a matter of judgment due to the fact that examinations, and by extension settlements, occur in a variety of ways. [10] This is an acknowledgement by the FASB that settlement is not always evidenced by a defining moment, but can take many forms and does require management to analyze if settlement has occurred on its open tax positions.

SUBSEQUENT RECOGNITION, DERECOGNITION, AND MEASUREMENT

Realizing that taxes exist in a dynamic environment, the FASB provided for recognition or derecognition subsequent to the initial decision. Subsequent recognition is to occur in the first interim period in which one of three conditions is met:

- The MLTN threshold is met by the reporting date.
- The tax matter is settled through negotiation or litigation.
- The statute of limitations expires. [9]

Derecognition occurs when a previously recognized position no longer meets the MLTN threshold. This adjustment is made in the first period that the position falls below the recognition threshold. The adjustment must be treated as a decrease in the amount of the expected tax benefit. The use of a valuation allowance is not allowed. [9]

Subsequent recognition, derecognition, or change in measurement is based on management's best judgment of the facts, circumstances and information available at the reporting date. A change in judgment derives specifically from the evaluation of new information and not from a new evaluation or interpretation of previously available information. [9] Thus, there is another compelling reason to be certain that the initial analysis of the tax position in thorough and not done in a hasty manner.

INTEREST AND PENALTIES

The Interpretation provides for the recognition of interest and penalties that may accrue under certain circumstances. If the tax law requires that interest be paid on an underpayment of income taxes, interest expense should be accrued in the first period interest would begin accumulating. This is treated as a period cost. [9] The Interpretation gives the enterprise the latitude to classify interest as income tax expense or interest expense. [23]

FIN 48 apparently considers an unrecognized tax benefit as a loan from the government, with the resultant interest charges. Therefore the basis for the interest charge is the difference between the tax position recognized in the financial statements and the amount claimed on the tax return. [23] It should be noted that, due to net operating loss carryforwards and tax credit carryforwards, it is possible that no interest would be due. However, this is a provision in the United States tax code, and my not be present in the codes of other nations. [23] If the tax code of a particular country does not recognized net operating loss carryforwards, it would be in the position of recognizing interest payable to the foreign country, but not recognize any in the United States.

Likewise, if the position does not meet the minimum statutory threshold to avoid penalties, an expense shall be recognized for the amount of the penalty. This penalty is to be recognized in the period that the enterprise claims the position on the tax return. [9] It should be noted that this penalty is recognized only for financial statement purposes, as penalties are not deductible items for tax returns.

Unrecognized tax benefits and the related penalty and interest exposures usually result in a FIN 48 liability, as the company may be obligated to make those payments to the taxing authority. Due to the nature of the process, this will most often be a long-term liability. The Interpretation is very specific in stating that this liability is not a component of deferred taxes. [9]

DISCLOSURES

The most controversial area of FIN 48 is in the area of disclosures. There is obviously a reluctance on the part of taxpayers to disclose uncertain tax positions. It is not an unfounded fear that the taxing authorities may use these disclosures against the enterprise. It is not unlike a poker player showing his hand – the other side knows your position. On the other hand, these same financial statements and disclosures are read by investors, who make decisions based on these (as well as other) disclosures. So this highly sensitive area of disclosures requires a great deal of judgment on the part of standard setters in determining what must be disclosed and upon management in determining just what will be disclosed. All of this must be done while fulfilling GAAP requirements and satisfying investors with a proper level of disclosure.

Several of the disclosures are of little consequence. One disclosure requires the enterprise to disclose its policy on classification of interest and penalties in the footnotes to the financial statements. [9] As mentioned, the Interpretation does give enterprises a choice in classification of interest as interest expense or as income tax expense.

Secondly, FIN 48 requires that the current amount of interest and penalties shall be recognized on the statement of financial position and the total amount shall be aggregated on the balance sheet. [9] One issue here is in the area of preferability letters. The SEC Regulations Committee has stated that any changes in the income statement classification of interest and penalties connected with the adoption of FIN 48 will not require a preferability letter. However, any subsequent change in classification of these items will require such a letter. [20]

An additional disclosure requires the enterprise to report the total amount of unrecognized tax benefits that, if recognized, would change the effective tax rate. [9] In discussions with the FASB staff, PriceWaterhouseCoopers inferred that one purpose of this disclosure is to identify uncertainties not solely related to timing differences, but to permanent differences. This is in line with the wording given in the sample disclosure in the appendix to FIN 48. [17] This disclosure will require management to make a judgment of the effects that recognizing any unrecognized tax benefits will have on the effective tax rate, and should be supported by documentation. [19]

OPEN TAX YEARS

A fourth disclosure that does not seem to be very controversial requires the company to describe tax years that remain subject to examination by major tax jurisdictions. [9] Unless a company has committed fraudulent acts with no statute of limitations, this is a rather straightforward disclosure. However, care must be taken to correctly identify any open tax years and to properly identify “major tax jurisdictions.”

Even though this is a non-controversial area, it could lead to an increase in the filing of returns. It is not always completely clear if a company has a nexus in a certain tax jurisdiction. As a result of this uncertainty, along with a perceived low-risk if it is determined that the enterprise has a nexus, companies have opted not to file returns in many instances. [24] However, under FIN 48 companies may be rethinking this strategy. First, the required disclosures could alert the taxing authority to areas that are fertile grounds for successful audits. In essence providing the taxing authorities with a roadmap directing them to areas where additional tax dollars can be obtained. Second, if the enterprise makes a judgment not to file a return in a certain jurisdiction, that becomes an open tax position. Even though the position does not meet the “more likely than not” criteria, it must still be disclosed. The decision not to file a return means that the tax position will remain open, as there is no statute of limitations associated with not filing a return.

Faced with a long list of unresolved, open tax positions some companies are seeking to shorten this list. As a result, certain companies are making anonymous inquiries to state departments of revenue regarding the state's willingness to resolve the matter on a compromise basis in terms of taxes, interest, and penalties. If the state is willing to compromise, the companies are coming forward, resolving the issue, and not being forced to disclose an uncertain tax position. [15]

In an effort to assist taxpayers, the IRS offered a "fast track" resolution of uncertain tax positions. This initiative gave taxpayers a mechanism for resolving uncertain tax positions prior to the publication of its financial statements for years ending on or before March 31, 2007. [14] Although this did not introduce any new dispute resolution methods, it did require IRS personnel to attempt to follow procedures to speed up the resolution of the issue. IRS personnel were required to respond within one day of receiving the request. One negative aspect of this initiative is that the IRS insisted that the taxpayer disclose all "original documents" relating to the taxpayer's risk assessment of the issue. [15] Obviously, this would inhibit some from proceeding along this route.

Obviously, companies must be very proactive in its identification of open tax positions. These positions will require continual monitoring and assessment of each position. Additionally, companies should seek opportunities to resolve any such issues to avoid excessive exposure to open tax positions.

CHANGES IN UNRECOGNIZED TAX BENEFITS

One disclosure that may require management to consult its crystal ball requires the enterprise to disclose positions where it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date. [9] This disclosure must include:

- The nature of the uncertainty
- The nature of the event that could occur in the next 12 months that would cause the change
- An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made. [9]

For this qualitative and quantitative disclosure, management is charged with the task of determining that there is an uncertainty in a tax position, of identifying the nature of an event that could occur, and then estimating the financial impact of that uncertain change from a possible event.

There are at least three areas of difficulty in this disclosure. First is the concept of "reasonably possible." In its policy manual under accounting for contingencies, Harvard University defines reasonably possible as "the chance of the future event or events occurring is more than remote, but less than likely." [11] Others define this term in a similar manner. In an article entitled "Probability and Materiality" Price and Wallace observe that in using terms such as reasonably possible, the FASB may have an "intended symmetry" of likelihood. They suggest an eight-point likelihood continuum from remote to probable. [16]

This second area of difficulty with this disclosure is the amount of the change. If one determines that there is a reasonable possibility that a change will occur, management must then turn to the task of measuring that change.

Price and Wallace suggest taking the probability measurement one step further and map likelihood with materiality. Under this approach, the decision-maker would analyze the likelihood of an event, but intersect that likelihood with materiality. [16] This would allow management to evaluate disclosures in terms of a combination of materiality and probability. It would seem that this approach would be well suited to disclosing reasonably possible changes in unrecognized tax benefits. However, it does carry the burden of significant judgment and uncertainty on the part of management. This is not an approach that lends itself to casual use.

A third area of concern deals with the extent to which financial auditors will require disclosures of individual positions and jurisdictions. Some are of the opinion that no disaggregated information for individual tax positions or jurisdictions is required. [23] Others disagree. In discussing "reasonably possible" changes in recognized tax benefits for the coming 12 months, there is concern that more specificity will be required even to the extent of identifying specific jurisdictions. [15]

RECONCILIATION OF UNRECOGNIZED TAX BENEFITS

The final disclosure is probably the most controversial. The enterprise is required to disclose at the end of each accounting period a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning of the period and the end of the period. This disclosure is on a world-wide aggregated basis and must include at a minimum:

- The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.
- The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period.
- The amounts of decreases in the unrecognized tax benefits as a result of settlements with taxing authorities.
- Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations. [9]

Even though these are unrecognized disclosures, those that do not meet the "more likely than not threshold," management is required to disclose any and all of these unrecognized tax benefits.

Once it is determined that a portion or all of a material tax benefit that was claimed on a return is not likely to be sustained, the expense must be booked or disclosed in the notes to the financial statements. There is a great deal of concern that these disclosures cold provide a roadmap for examination by the IRS or other taxing authorities. [15] This issue of uncertain tax positions and the determination of an enterprise's tax reserves has a potential impact on auditor independence. Company auditors are not likely to blindly accept a company's analysis of its uncertain tax positions without viewing the detail behind the amount. Since the auditor certifies the tax reserves, the firm will likely need tax advice from a firm other than its auditor. [22] This can remove the auditor from a detailed examination of the tax reserve issue.

Lurking behind this concern of providing the IRS with a roadmap of the tax positions of an enterprise is the long-held IRS Policy of Restraint. In *U. S. v. Arthur Young & Co*. in 1984, the Supreme Court affirmed the right of the IRS to obtain tax accrual workpapers. Following this ruling, the IRS announced a policy of voluntary restraint with procedural safeguards regarding workpapers. The IRS stated that they would continue its current policy of requesting tax accrual workpapers only in unusual circumstances. Enterprises and auditors are concerned, however, what appears to be an erosion of this policy. In 2002, the IRS issued announcement 2002-63, stating that the IRS may request the workpapers when it audits returns that claim a tax benefit from tax-avoidance transactions that have been identified as abusive. As explanation, the IRS justified this "limited expansion" of the Policy of Restraint on the grounds that it is "necessary to allow the Service to fulfill its obligation to the public to curb abusive tax avoidance transactions *and to ensure that taxpayers are in compliance with the tax laws*." (Emphasis added) [13] It is the latter portion of this statement that gives concern in light of FIN 48.

Donald Korb, IRS Chief Counsel stated that this does not signal a move by the IRS to more aggressively pursue tax accrual workpapers, stating that the IRS has limited the policy at what it was intended for. It has had a prophylactic effect of tax shelters, he continued. [4] However, seven months later, Korb said that the IRS plans to continue issuing summonses and requests for tax accrual workpapers in cases where taxpayers refuse to turn over information based on privilege claims. He added that the "so-called privilege in tax cases is not very broad. [3]

IRS Chief Counsel Notice CC-2007-15, issued in June, concludes that effective tax rate reconciliation workpapers are neither tax accrual workpapers nor audit workpapers. These will not be routinely requested during an audit. The Notice also concludes that documents produced by a taxpayer or the auditors of the taxpayer to substantiate uncertain tax positions in compliance with FIN 48 are treated as tax accrual workpapers. On its face, this should give us some reassurance. [14a]

On the other hand, tax reconciliation workpapers may be routinely requested during an audit. Tax reconciliation workpapers are defined as "workpapers that are used in assembling and compiling financial data preparatory to placement on a tax return." These typically include trial balances, a schedule of consolidating and adjusting entries, and information used to trace financial information to the tax return. Any tax return preparation document s that reconcile net income to taxable income are also included in this category. [14a]

Tax accrual workpapers are defined as "those audit workpapers, whether prepared by the taxpayer or the independent auditor, that relate to the tax reserve for the 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." [14a]

However, this Chief Counsel Notice states that effective tax reconciliation workpapers are not tax accrual workpapers because they are not prepared to determine the proper amount of the reserve for contingent tax liabilities. Nor are they audit workpapers in the sense of workpapers retained by the auditor to document the performance of the audit. [14a]

This Notice appears to be in conflict with statement made by the Korb shortly before its issuance. He stated that the IRS is "not going to turn a blind eye" to the tax reserve details disclosed under FIN 48. Repeating this no less than four times during his speech, he made it abundantly clear that IRS field agents will be reviewing the disclosures describing the nature and size of corporate tax reserves. [14b]

Two recent court cases indicate an aggressiveness on the part of the IRS. In the U.S. v. Roxworthy case, the IRS sought enforcement of a summons for two tax opinions in the possession of the taxpayer, Yum! Brands, Inc. The IRS argued that these papers were not protected under the work-product doctrine and had been prepared for penalty protection and not in anticipation of litigation. The Sixth Circuit court held that a document can be created for use in the ordinary course of business and in anticipation of litigation. Of note was the two-part standard adopted by the court. Part one (subjective) is a determination of whether the document was prepared in anticipation of litigation. Part two is whether the anticipation of litigation was objectively reasonable. [12]

In the second recent case, U.S. v. Textron, the IRS took a much more aggressive approach, seeking all of the tax accrual workpapers of Textron, Inc. and its subsidiaries. They asserted that Textron Financial Corp. engaged in six separate sale-in, lease-out transactions in 2001, and that these were listed transactions under Notice 2005-13. [12] In the Textron case, the facts are fairly straightforward: Textron's in-house counsel provided the accountants a spreadsheet that lists the issues identified by the tax advisors, and the hazards of litigation percentage for each issue. The IRS is asserting a right to these documents. Textron is asserting three privileges:

- Attorney-client.
- Section 7525 which provides a client with a privilege similar to an attorney-client privilege when they make certain tax-related disclosures.
- Work-product [5]

Regardless of the results of this case, the important point to note about this case is the new aggressiveness of the IRS in pursuing tax accrual workpapers. There is some thought that the IRS is taking this approach to use it as a "bargaining chip" to force Textron accept certain settlement terms. [12] There is an additional concern at this juncture. Concerning the attorney-client privilege, if a tax attorney prepares a tax position for reporting purposes, this becomes a part of the auditor's work papers. Since the work of the tax attorney has been shared with the auditors and made a part of their report, the attorney-client privilege is lost. [24]

An indication of the concern regarding the erosion of the Policy of Restraint is an action by the American Bar Association's House of Delegates. In August, 2006, this policy-making body voted unanimously in favor of a resolution urging federal regulators and the accounting and legal profession to adopt standards, policies, practices, and procedures to ensure that attorney-client privilege and work-product protections are preserved through the audit process. [6]

One reason given for the new aggressiveness by the IRS in pursuing tax accrual workpapers is the pressure on the IRS to close the tax gap; to collect more tax through the audit process. As this pressure mounts, the IRS may very well reconsider their Policy of Restraint. [24] Regardless of the reason for the IRS to reconsider their Policy of Restraint, the fact is companies will be very reluctant to disclose anything that the IRS could use against them in an audit or other proceeding. It could be that FIN 48 disclosures would give the IRS a roadmap in the pursuit of more successful audits (from the IRS view of a successful audit).

SUMMARY

FIN 48 is a step in the right direction. It does clarify accounting for income taxes and moves the accounting community toward conformity in reporting uncertain tax positions. However, the third objective expressed by the FASB may not have been achieved. While FIN 48 establishes consistent thresholds it does not appear to improve financial statement reporting

A company may have an uncertain tax position that does not meet the more likely than not threshold. Under this FIN 48, this position is not included in the financial statements but is disclosed. However, consider the scenario in which a company has such a position, but is almost certain to realize some tax benefit from it. The enterprise is prohibited from recognizing this benefit due to the failure of the position to meet MLTN. By omitting certain assets or liabilities from the balance sheet, one question if there is improved financial reporting.

A second area of concern is with the required disclosures in FIN 48. There is a fear that the disclosures of unrecognized tax positions may serve as a roadmap to guide tax authorities to areas that may yield productive audit activity. Coupled with the apparent erosion in the IRS policy of constraint this is no small matter for concern. In addition the disclosures require management to exercise judgment regarding changes in the unrecognized tax benefits. It seems that the FASB has placed an inordinate amount of focus on the unrecognized tax benefits to the point where the cost of complying with FIN 48 exceeds the benefits that are derived from its implementation.

Once companies have worked through a year of FIN 48 implementation the road ahead should be less difficult. Make no mistake, however. The costs and efforts of maintaining the enterprise's FIN 48 position will be difficult and costly. One can hope that the FASB will be forthcoming with additional guidance as well as adjustments making FIN 48 a more useful interpretation.

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