

FIN 48, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES: FASB CREATES A SHINY NEW ENFORCEMENT TOY FOR THE INTERNAL REVENUE SERVICE

The Financial Accounting Standards Board on July 13th issued a new Financial Interpretation 48, Accounting for Uncertainty in Income Taxes ("FIN 48"). In outlining the reasons for adopting this interpretation, FASB stated:

[I]n some cases, the law is subject to varied interpretation, and whether a tax position will ultimately be sustained may be uncertain. . . . As a result, diverse accounting practices have developed resulting in inconsistency in the criteria used to . . . measure benefits related to income taxes. This diversity in practice has resulted in noncomparability in reporting income tax assets and liabilities.

To create consistent reporting across enterprises, FIN 48 treats the financial reporting of "tax positions" as a two-step process: first, a tax position may not be included in an enterprise's financial statements unless it is "more likely than not" to be sustained upon examination. Second, even if a tax position meets this reporting threshold, the amount reported is measured as the largest amount of benefit that is greater than 50 percent likely of being realized.

How FIN 48 Works

Let's unpack these concepts. First, "tax position" is very broadly defined: it is a position in a previously filed tax return or one expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities. Moreover, the term encompasses (1) a decision not to file a tax return, (2) decisions on allocating or shifting income between jurisdictions; (3) the characterization of income or a decision to exclude income from a tax return; and (4) a decision to classify a transaction, entity, or other position as tax-exempt.

Second, FIN 48 specifies that, in evaluating whether a tax position is more likely than not to be sustained, only the technical merits of the position matter, and the enterprise must presume that the position will be examined by the appropriate taxing authority who will have full knowledge of all relevant information. Further, each tax position must be evaluated on its own technical merits, without considering the possibility that it could be aggregated, offset, or favorably settled. In other words, one cannot take into consideration the "audit lottery," the [in]competence of the reviewing agent, the hazards of litigation to the taxing authority, or other practical criteria that enterprises have historically used to justify or support claiming tax benefits in their financial statements.

Third, and perhaps most confusing, the tax benefit shown on the financial statements is not simply the amount of the tax position taken on the return. Rather, an enterprise is required to quantify "the amounts and probabilities of different outcomes that could be realized upon ultimate settlement . . ." of the tax position. Only the largest amount that has a greater than 50 percent likelihood of being realized can be claimed as a tax benefit on the financials. Thus, for example, if a tax position is 10 percent likely to produce a tax benefit of \$100, 35 percent likely to produce a tax benefit of \$80, 20 percent likely to produce a tax benefit of \$65, and 35 percent likely to produce a tax benefit of \$40, the financial statements would show a tax benefit of \$65, because in more than 50 percent of the cases, a tax benefit of \$65 or greater is expected to be realized.

In addition to analyzing and measuring tax benefits themselves, FIN 48 requires an enterprise to expense applicable interest at the statutory rate, beginning in the first period that these items would accrue under the relevant tax law. Moreover, if a tax position does not meet the minimum statutory threshold for avoiding penalties, FIN 48 requires the enterprise to book the penalty amount as an expense in the accounting period in which the enterprise claims or expects to claim the position in a tax return.

These rules are applied when a tax position is first taken, or upon initial adoption of FIN 48 by an enterprise. Thereafter, tax benefits are derecognized or recalculated if, for example, the law changes, the matter is ultimately settled through litigation or negotiation, or the statute of limitations expires.

Supplemental Disclosures

In each annual reporting period, FIN 48 also requires an enterprise to disclose:

- A tabular reconciliation of unrecognized tax benefits at the beginning and end of the period, including at a minimum:
 - o Increases and decreases in unrecognized tax benefits relating to positions taken in prior periods;
 - o Increases and decreases in unrecognized tax benefits relating to positions taken in the current period;
 - o Decreases in unrecognized tax benefits relating to settlements with taxing authorities; and

continued . . .

- o Reductions to unrecognized tax benefits due to lapse of statutes of limitations.
- The total amount of unrecognized tax benefits, recognition of which would affect the effective tax rate
- The total amounts of interest and penalties recognized either in the balance sheet or income statement
- If it is "reasonably possible" that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date, the enterprise must disclose:
 - o The nature of the uncertainty;
 - o The nature of the event that could cause such change; and
 - o An estimate of the range of such change (or a statement that such range cannot be estimated).
- A description of tax years that remain subject to examination by major tax authorities

Effective Date

FIN 48 applies for fiscal years beginning after December 15, 2006; however, earlier adoption is encouraged. The cumulative effect of applying FIN 48 to preexisting tax positions must be disclosed, presented separately as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the balance sheet).

What FIN 48 Means to an Enterprise

FIN 48 is an interpretation of FAS 109, the standard on Accounting for Income Taxes and, thus, required to be followed in preparing financial statements under GAAP. In adopting FIN 48, FASB stated plainly its expectation that the effect of adopting FIN 48 would be to (A) increase reported liabilities for income taxes payable or reduce refunds receivable, (B) reduce deferred tax assets or increase deferred tax liabilities, or (C) both. In other words, enterprises that have been taking aggressive tax positions will report lower retained earnings, lower income, higher liabilities, or all of the above.

In addition, the tabular reporting and specific disclosure with respect to interest and penalties will highlight the potential cost of the aggressive positions to the enterprise, even before those financial detriments come to pass.

Commentators are already pointing out that FIN 48 will provide a road map for the Internal Revenue Service and other taxing authorities to seek to impose greater tax liabilities. As a first cut, we anticipate that the IRS will target for examination all public enterprises that show any significant adjustment to earnings, assets or liabilities due to the adoption of FIN 48. Then, the specific disclosure should assist a reviewing agent to home in on material transactions and events the economic results of which funnel into the adjustment. Although private companies are not required to make their financial statements public, any private company that prepares GAAP financials for lenders, investors or otherwise, will now have to wrestle with the fact that FIN 48 requires disclosure of sensitive information which will not be subject to the attorney-client or work product privilege. Not to mention wrestling with the costs – which are likely to be significant in the short run – of having its accountants evaluate each and every tax position in an open tax year for its likelihood of success on the merits and the amount that is more than 50 percent likely to be realized.

Against this background, it appears that another trend is developing: enterprises are seeking a higher level of comfort from their tax advisors than merely "more likely than not." This development appears to be mathematically oriented: if an opinion finds only a 51% likelihood that a position will be sustained, then the amount of tax benefit reportable under FIN 48 is likely to be lower than what is shown on the return, leading to a specific disclosure and, therefore, a higher audit risk. In contrast, if the tax advisor opines that a transaction "should" or "will" be sustained (roughly translating to 70+% and 90% levels of certainty), it becomes likelier that the amount of tax benefit reportable will be the same as, or close to, the amount claimed on the tax return.

At this early stage, it is impossible to tell whether the IRS or other taxing authorities will be in a position to take advantage of the flood of new information available to them to spot tax cheats, or whether enterprises and their advisors will find unexpected ways to conclude that their aggressive transactions are not required to be disclosed under FIN 48. For the moment, all that can truly be said is that FASB may have achieved what has so far eluded the IRS and other taxing authorities: a disclosure mechanism that is reasonably tailored to uncovering aggressive tax positions on a timely basis, without the necessity of opening an audit. Stay tuned.

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