ALM
LAW JOURNAL NEWSLETTERS
LJN'S
Equipment Leasing Newsletter®
Volume 26, Number 8 • September 2007

An Overview of FIN 48

Accounting for Uncertain Income Tax Positions

By Peter H. Gruen and Lindsay M. LaCava

In an effort to increase comparability and consistency in how companies report income tax positions on financial statements, the Financial Accounting Standards Board ("FASB") issued on July 13, 2006 FASB Interpretation Number 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes*. FIN 48 changes the way companies must account for uncertain tax positions taken on federal, state and local, and international income tax returns for financial reporting purposes. Despite the requests for delay by numerous companies and trade and lobbying groups, the provisions of FIN 48 became effective for fiscal years beginning on or after Dec. 15, 2006. The provisions of FIN 48 apply broadly to all companies that issue financial statements in accordance with generally accepted accounting principles ("GAAP") and that are potentially subject to federal, state and local, or foreign income taxes.

BACKGROUND

FIN 48 shifts the way companies must evaluate tax positions for financial reporting purposes from a contingent-liability model to a benefit-recognition model. Prior to the enactment of FIN 48, the tax benefits of a tax position taken on an income tax return were generally recognized in a company's financial statements. Companies then accounted for uncertain income tax positions using the contingent-liability model set forth in Financial Accounting Standard 5 ("FAS 5"), *Accounting for Contingencies*. Only income tax positions judged to be uncertain were evaluated under FAS 5, and a loss contingency was booked only when it was probable that the tax benefit resulting from the tax position would be lost if challenged and the amount of such loss could be reasonably estimated.

Under the benefit recognition model implemented by FIN 48, every material tax position taken on an income tax return must be evaluated using a two-step approach. This approach first requires a determination of whether a tax position has met the recognition threshold, and then requires a determination as to how the tax position should be measured. In contrast to the contingent-liability model, only tax positions that meet the recognition criteria are recognized as a tax benefit on a company's financial statements. FIN 48 also attempts to increase the transparency of income tax positions to investors by requiring companies to make disclosures in financial statements regarding uncertain tax positions.

This article provides a brief overview of the two-step, benefit-recognition approach implemented by FIN 48, a summary of the disclosures required by FIN 48, and a discussion of various issues associated with protecting the documentation necessary to comply with FIN 48 from disclosure to taxing authorities.

A SUMMARY OF THE TWO-STEP PROCESS

Recognition

The first step in evaluating an income tax position under FIN 48 is to determine which tax positions taken on an income tax return should be recognized in the company's financial statements. This involves identifying all material positions taken on any income tax return — federal, state and local, and international — for all tax years that are still subject to assessment or challenge by the relevant taxing authority. Tax positions can encompass a variety of issues, including the claiming of an income tax deduction, the decision not to file a return in a particular jurisdiction, an allocation or shifting of income between jurisdictions, the characterization of income, the decision to expense or capitalize an expenditure, the decision to exclude taxable income on a tax return, and the decision to classify a transaction, entity or other position in a tax return as tax-exempt. Only those tax positions taken on an income tax return that are "more likely than not" to be sustained based on the technical merits can be recognized as a tax benefit on a company's financial statements.

The more-likely-than-not threshold requires that there be a more than 50% chance that the tax position claimed on an income tax return would be sustained if challenged and considered by the highest court in the relevant jurisdiction. In the event a tax position does not meet the more-likely-than-not threshold in the period in which the tax position is taken on a return, a company must recognize the benefit of the tax position for financial reporting purposes in the first interim period in which the threshold is met; the tax position is effectively settled through examination, negotiation or litigation; or the statute of limitations for the relevant taxing authority to examine and challenge the position has expired. FASB staff have recently clarified, in FASB Staff Position FIN 48-1, that a tax position is "effectively settled" when the taxing authority has completed its examination procedures, including all appeals and administrative reviews, the enterprise does not intend to appeal or litigate any aspect of the tax position, and the chances are remote that the taxing authority would examine or re-examine any aspect of the tax position.

Measurement

With respect to tax positions that meet the more-likely-than-not recognition threshold, the second step is to determine how much of the tax benefit should be recognized. The amount of tax benefit that should be recognized on the financial statements is not necessarily the full amount of tax benefit claimed on the income tax return. Rather, companies must analyze with respect to each recognized tax position the amount and probability of possible outcomes that could be realized upon settlement with a taxing authority that has full knowledge of all relevant information using the facts, circumstances, and information available as of the financial statement reporting date. Companies only recognize the largest amount of tax benefit that has a greater than 50% likelihood of being realized upon settlement with a taxing authority. It should also be noted that with respect to tax positions that do not meet the more-likely-than-not threshold, FIN 48 requires companies to accrue and recognize interest and penalties that would be incurred if the uncertain tax positions were not ultimately sustained by the relevant taxing authority.

Required Financial Statement Disclosures Under FIN 48

FIN 48 also requires companies to make disclosures on their financial statements regarding uncertain income tax positions at the end of each annual reporting period. Specifically, companies must include a tabular reconciliation of total unrecognized tax benefits at the beginning and end of a period, the total amount of unrecognized tax benefits that, if recognized, would affect the company's effective tax rate, the total amounts of interest and penalties recognized with respect to unrecognized tax benefits, certain information regarding positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within the next 12 months, and a description of tax years that remain subject to examination by "major" tax jurisdictions. At this point, it is unclear what constitutes a major tax jurisdiction.

There has been a great deal of speculation as to whether these required disclosures will provide a "roadmap" to taxing authorities when examining income tax returns. In a Field Examiners' Guide published in May 2007 by the Large and Mid-Sized Business Division (LMSB-04-0507-045), the IRS stated that FIN 48 disclosures should be carefully reviewed and analyzed as part of the audit planning process. However, the full nature of these disclosures and their usefulness to taxing authorities will not be fully apparent until companies start issuing year-end financial statements. Interim reporting is not required under GAAP, and although public companies are required to issue quarterly reports, the SEC is not requiring full FIN 48 disclosures in interim reports. In drafting the year-end disclosures required by FIN 48, companies should be cognizant of the risks associated with providing too much information, while still providing the information necessary to comply with FIN 48 and meet the scrutiny of independent auditors.

FIN 48 Documentation

Because the documentation necessary to support a company's calculation of tax benefits under FIN 48 will involve a more extensive analysis of a company's tax risks than required in the past, companies should try to protect this documentation from disclosure to taxing authorities. The documentation necessary to support the evaluation of tax positions under FIN 48 will likely include formal tax opinions and legal memoranda analyzing various tax positions, supporting calculations, and settlement risk analyses.

One area of concern has been whether the IRS will request FIN 48 documentation during the examination process. The IRS Office of Chief Counsel issued a memorandum on June 8, 2007 (AM 2007-10012) stating that the IRS will treat FIN 48 workpapers in the same manner as tax-accrual workpapers. Although the IRS has the legal authority to request tax-accrual workpapers, the IRS currently has a policy under which examiners do not request tax-accrual workpapers as a routine examination technique unless the taxpayer was involved in a "listed transaction" as defined under the tax-shelter rules. This recent announcement gives some reassurance to taxpayers that FIN 48 documents are generally safe from disclosure to the IRS, but there is no guarantee that the IRS will refrain from requesting tax-accrual workpapers in the future. Further, there is no certainty that the IRS will not re-characterize a particular transaction as a listed transaction in the future, which may put a taxpayer's accrual workpapers at risk for disclosure. As a result, companies should make efforts to further safeguard certain FIN 48 documentation from disclosure to taxing authorities.

Although the attorney-client privilege will not protect documents that are shared with independent auditors, the work product doctrine may be available to protect certain documents that are prepared in anticipation of litigation. Many of the documents that companies will use to support conclusions reached during the recognition step of the FIN 48 process will analyze the risks associated with a particular tax position and the likelihood that the position would be sustained upon challenge by a taxing authority. Although it is unclear, these documents may be eligible for protection from disclosure under the work-product doctrine if the company can show that the documents were prepared solely in anticipation of litigation rather than for financial statement purposes, even though the documents may ultimately serve a dual purpose.