Understanding FIN 48, Accounting For Uncertainty In Income Taxes, And Resulting Implications Under Sarbanes-Oxley

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This is another in a continuing series of articles written by members of the ABA Tax Section in which a senior member of the Section teams up with a member selected from the Section’s Young Lawyers Forum.

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CORPORATE TAXPAYERS, AS WITH MANY TYPES OF TAXPAYERS, frequently consider tax minimization or avoidance strategies. Invariably, this evaluation concludes with whether a taxpayer should go forward with a particular planning strategy or possibly weigh competing strategies. In many cases a principal goal of the selected strategy is to reduce or defer current period Federal (and/or state) income tax liabilities. (When a tax opinion is rendered, certain compliance and ethical issues are implicated. §§6694, 6664(c). See Circular 230, 31 C.F.R. §10.35(c) (covered written opinion rules; “principal purpose,” “significant purpose”). For reporting rules and list maintenance requirements for certain “reportable transactions” see Treas. Reg. §1.6011-4.) The objective of reporting a reduced tax liability as a consequence of entering into one or more tax-efficient transactions is to facilitate a corresponding reduction in the taxpayer-company’s current or projected cash outflows, including estimated tax and tax reserves. Where projected tax savings are currently viewed by management as ultimately being realized, the projected amount of the benefit is further reflected on the balance sheet of the taxpayer as an
indirect increase to retained earnings, i.e., by not being included as a contingent liability in the reserve for taxes.

Not all of a reporting enterprise’s planned positions taken on a tax return, however, will be sustained in the event of an audit. If a particular reporting position is successfully challenged in court by the IRS, settled by agreement, or conceded by the taxpayer in whole or in part, the taxpayer will incur an interest cost which accrues from the due date of the return, i.e., the required date of payment, as well as a possible penalty (and deficiency interest on such penalty) until the date of payment (or if earlier, when a deposit in the nature of a cash bond is made). §§6601, 6603, 6621(a)(2). Although tax returns that initially report a favorable outcome or result on one or more issues reflect the benefit of a reduced current tax liability owed by a corporate taxpayer (or increase in a reportable net operating loss or increase to a claim of refund), the claimed tax benefits still have to be analyzed for financial reporting purposes to avoid being shown as contingent tax liabilities includible in a properly established reserve.

**FASB 109** • Before the adoption of FAS Interpretation No. 48 (“FIN 48”), Financial Accounting Standards Board (“FASB”) Statement 109 (adopted in 1992) did not set out specific guidance concerning the proper method for reporting uncertainty in income tax liabilities for financial accounting purposes. The approach used before the promulgation of FIN 48 was for the reporting entity to increase its reserve for taxes based on whether and to what extent management believed it was likely that the positions taken by the taxpayer on returns would ultimately give rise to an actual liability, including additions to tax. This process involved examining whether the outcome with respect to the particular item or items was probable, reasonably possible, or improbable. In such latter instances, a charge for the possible payment of taxes upon audit may have been completely left off the taxpayer’s tax reserve.

This liberal yet amorphous standard yielded diverse approaches for booking reserves for taxes. More particularly, when the likelihood that a particular reported tax position would ultimately be sustained was uncertain, FAS 109 had no specific guidance on how and whether the position should be booked to a reserve for tax liabilities, and the amount of the charge if booked. As a result, diverse accounting practices developed to reflect tax reserves. This inconsistency in recognizing, derecognizing, and measuring benefits and liabilities associated with income taxes made it difficult for investors to properly analyze and compare financial statements of different enterprises.

**FIN 48** • In light of other relatively recent financial reporting issues and business scandals, the Securities and Exchange Commission, particularly after the enactment of the Sarbanes-Oxley Act, H.R. 3763, 107th Cong. (2002) (“SOX”), was critical of the lack of consistency and transparency in accounting for uncertainty in income taxes. This criticism led to the adoption of FIN 48. FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109,” Financial Accounting Series (June 2006).

**Scope Of FIN 48**

FIN 48 clarifies the guidelines for accounting for uncertainty in income taxes on financial statements of enterprises per FASB Statement No. 109, Accounting for Income Taxes, and removes uncertain income tax positions from the guidance provided under FAS 5, Accounting for Contingencies. It also applies to purchase accounting in connection with a business combination. Use of a valuation allowance described in FASB Statement 109, therefore, is not an appropriate substitute for the derecognition of a tax position. The requirement to assess a
valuation allowance for deferred tax assets based on the sufficiency of future taxable income is left unchanged by FIN 48. This situation would arise, for example, when a company with a large net operating loss carryforward is not likely to produce a sufficient level of future taxable income to fully use the NOL within the applicable carryover period.

When a position is taken on a tax return that reduces the amount of income taxes payable even though another interpretation of current law can be made that would not reduce those taxes, the enterprise realizes an immediate economic benefit. Under FIN 48, this benefit of a favorable tax position can be recognized in the current period when the position has a “more likely than not” chance of being upheld through court review despite the presence of contrary interpretations, and such benefit to ultimately be realized can be measured in accordance with applicable rules. Only the difference between the measured benefit and the reported benefit on the tax return is required to be added to the tax reserve. On the other hand, if the position on a particular item, i.e., a so called unit of account, is determined to be “less likely than not correct,” the full amount of the tax liability, as well as projected interest and possible penalty, must be included in the reserve as a current liability (or reduction in the net operating loss carryforward or claimed tax refund) when the company anticipates making payment within one year or within the company’s next operating business cycle. Non-current liabilities for fully or partially unrecognized tax positions are treated as a deferred tax liability to the extent unrecognized. Such book-tax adjustments will, in certain instances, affect the tax basis of one or more assets, thereby differentiating book from tax depreciation—during the applicable recovery periods.

In many instances partial or totally unrecognized tax positions may not later be derecognized, i.e., reduce the amount of the reserve or liability for uncertain taxes, until the statute of limitations has expired for the year in which the position(s) were taken and the position(s) has not been challenged by the taxing authority. Conversely, previously recognized tax positions that subsequently fail the “more likely than not” recognition standard due to an intervening change in the law are required to be derecognized and charged to liabilities in the first subsequent financial reporting period in which such determination is made.

When the “more likely than not” standard is not satisfied, as is discussed below, no economic benefit may be claimed and recognized for financial accounting purposes, i.e., a liability is booked or reflected on the financial balance sheet for the total amount of tax due, plus associated interest and penalties.

**IMPACT OF FIN 48 ON REPORTING COMPANIES AND PRIVATELY HELD COMPANIES PREPARING FINANCIAL STATEMENTS UNDER GAAP** • In June 2006, FASB approved the final version of FIN 48 for generally accepted accounting principles (GAAP) reporting with respect to uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006, for public companies, and, for fiscal years beginning on January 1, 2007, for non-publicly traded or privately held calendar-year companies. Originally, the same 2006 effective date was to apply to all entities using GAAP for financial accounting purposes. However, based on a November 2007 recommendation of the Private Company Financial Reporting Committee, FASB agreed to delay the effective date until taxable years beginning on January 1, 2008, for private companies to comply with FIN 48. See also FASB Staff Position FIN 48-2 (2/01/08), (effective date of the FASB Interpretation No. 48 for certain nonpublic enterprises, including nonpublic non-for-profit organizations, to the annual financial statements for fiscal years beginning after December 15, 2007). Again, it is critical to recognize that FIN 48 applies not only
to companies whose shares of stock are publicly traded and therefore are registered with the U.S. Securities and Exchange Commission ("SEC") in reporting "fair value" filings, but also to all entities and enterprises that report financial results under GAAP. The scope of FIN 48 extends to all entities that use the GAAP method for financial accounting purposes, including tax-exempt organizations as well as pass-through entities.

In setting forth this new and higher GAAP standard, FASB required reporting companies to recognize on their financial statements the best estimate of their tax positions. In abandoning the prior calculus of whether a tax item "probably, reasonably possibly, or remotely" would survive IRS review, FIN 48 establishes a "recognition" or "non-recognition" approach. For a tax position to be "recognized," it must have a more-likely-than-not chance of being sustained on the merits through audit, administrative, and judicial review. Once a position passes this threshold, as further discussed below, the expected benefits are subject to a set of measurement rules and principles to quantify whether part or all of the benefit is to be recognized.

The FIN 48 Two-Step Process

FIN 48 provides a detailed set of principles and applicable rules in determining how to treat such uncertain tax items, referred to as "units of account," and sets forth a two-step process to recognize and measure a tax position taken or expected to be taken on a tax return. FIN 48 is divided into various categories or segments, including guidance on the subjects of recognition, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. In general, differences in financial and tax accounting with respect to uncertain tax items will result in: (i) an increase in a liability for income taxes payable or a reduction of the amount of an anticipated income tax refund; and/or (ii) a reduction in a deferred tax asset or increase in a deferred tax liability. The required computations under this "liability method" can be quite complex. See FAS 109, ¶¶ 16, 17e, 20-21 (deferred tax expense, liability or asset).

FIN 48 applies to "tax positions" contained in a previously filed tax return or a position that will result in a permanent reduction in taxes currently payable or a deferral of income taxes to be paid until a future year. The tax liability for uncertain tax positions under FIN 48 is not included in the general label of deferred taxes. Rather, it must be classified separately from other tax balances based on the expected timing of cash flows to or from taxing authorities.

The term "position" includes:

- An allocation or shift of income between jurisdictions, e.g., intercompany pricing agreements under section 482;
- The characterization of income or a decision to exclude reporting taxable income, e.g., an assumed tax-free reorganization transaction without the presence of taxable "boot" or gain recognition;
- A decision to classify a transaction, entity, or other position contained in a tax return as tax exempt; and
- A decision not to file a tax return, for example, in a foreign jurisdiction based on the assumed correctness that such income is not taxable. (This last "position" of non-reporting is frequently of great importance in negotiating a tax indemnification clause pursuant to a merger or acquisition between a target and acquiring company.)

If management, upon its review and analysis, determines that the position will more likely than not be sustained in the event of audit by the IRS or judicial review of an IRS challenge, then such position can be currently recognized for financial accounting purposes as well. Still, a prior recognized position must be charged or reduced by the probable point at which the tax position will be resolved between the taxpayer and the IRS or applicable