

FIN 48: Measuring Tax Benefits in The Real World

By Neil D. Kimmelfield

Neil D. Kimmelfield is a shareholder in the tax practice group at Lane Powell PC's Portland, Ore., office.

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I am writing to comment on the recent article by William and Burgess Raby, "Quantifying Uncertain Tax Positions," *Tax Notes*, Oct. 9, 2006, p. 153, *Doc 2006-20188*, or *2006 TNT 196-31*. The article covers several points in connection with Financial Accounting Standards Board Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes," but one point in particular seems to be at the core of what many companies are confronting with the greatest perplexity — that is, how to apply the superficially straightforward recognition/measurement regime of FIN 48 in real-world situations.¹

In their article, the Rabys offer an example involving an assertion by a company's auditors that a portion of the company's claimed compensation deductions may be challenged, and possibly disallowed, as exceeding reasonable compensation. The deductions in question relate to compensation totaling \$2.5 million paid to four officers/shareholders, and the company's independent auditors have estimated that total reasonable compensation for that group is not more than \$1.3 million, based imprecisely on somewhat comparable prevailing-compensation information. The Rabys' fictional auditors suggest that, under FIN 48, "provision must be made for the difference between the tax benefit being claimed for the \$2.5 million and the tax benefit on the largest amount that is greater than 50 percent likely of being realized if it is assumed that the return is examined by the IRS and that the IRS acquires all information relevant to the officers' compensation."

¹The Rabys raise important questions about whether FIN 48 will actually produce comparability among companies in terms of the reported consequences of similar situations or will result in meaningful income measurement. My comments herein focus on the more prosaic questions of what companies must do to implement FIN 48 and what their tax advisers can do to assist them.

In response to the auditors' assertion, the company, together with a tax-litigator consultant, evaluates possible outcomes as follows:

| | Amount Allowed | Probability |
|--------------------------------------|----------------|-------------|
| Settlement with revenue agent | \$1.3 million | 32 percent |
| Settlement with IRS appeals officer | \$1.8 million | 30 percent |
| Settlement at TC level without trial | \$2.0 million | 25 percent |
| Decided after litigation | \$2.4 million | 13 percent |

Based on the apparent fact that "the amount allowed at which the cumulative probability of settlement exceeds 50 percent is \$1.8 million," the Rabys conclude that the company must book a FIN 48 liability corresponding to the tax benefit of the \$700,000 that, loosely speaking, is expected to be disallowed.²

Based on my own observations of FIN 48 discussions, I believe the Rabys have depicted fairly well how many CPAs are poised to implement the new rules, because, based on "illustrative guidance" in FIN 48's Appendix A, they believe that this is what they are supposed to do. Nonetheless, what is striking about the analytical procedure illustrated in the Rabys' example is that it does not implement the method that FIN 48 actually requires. The required method is both more complex and more rational. Moreover, following the required method reveals more than one point at which companies may exercise judgment and thereby affect the outcome.

²I use the phrase "apparent fact" because I am not sure what justifies the use of a "cumulative probability" analysis here. If the first column in the table was omitted, and the remaining columns identified the probability of each specified outcome in negotiations with a single adversary (for example, the revenue agent), the cumulative probability analysis *might* make sense. That is, the table would show that there is a 13 percent chance that the company and the adversary will settle at \$2.4 million, a 25 percent chance that they will settle at \$2 million, and a 30 percent chance that they will settle at \$1.8 million. Therefore, the cumulative probability that they will settle at \$1.8 million or more is arguably 68 percent. However, when the first column is taken into account, the cumulation analysis breaks down. For example, there is no indication in the table that there is any likelihood at all that the appeals officer would settle for more than \$1.8 million, and the probability of a \$1.8 million settlement is only 30 percent. Applying that observation at each level, there is nothing in the table that suggests there is a greater-than-50-percent probability of any dollar outcome.

COMMENTARY / VIEWPOINTS

The basic FIN 48 process involves the following three distinct steps:

- *Step 1:* Identify each “tax position” based on the appropriate “unit of account” (FIN 48, paragraphs 4-5).
- *Step 2:* Determine, for each tax position, whether it is more likely than not (MLTN) that the position would be sustained, based solely on the technical merits of the position, if the position were examined and litigated to the court of last resort (FIN 48, paragraphs 6-7, A2).
- *Step 3:* If and only if a positive MLTN determination is made under Step 2 regarding a tax position, recognize in the financial statement the greatest tax benefit from the position that is more likely than not to be realized, taking into account all facts and circumstances, including settlement prospects (FIN 48, paragraph 8, A3-A4).

The company depicted in the Rabys’ example appears to have skipped Step 1 and Step 2 and made its entire FIN 48 determination based on Step 3 alone.³ Let’s see what happens if we give more attention to the omitted steps.

Step 1: Determine the appropriate ‘unit of account’ and the ‘tax position.’ According to FIN 48, paragraph 5, determining the appropriate unit of account for applying FIN 48 should be based on “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.” In the Rabys’ example, it appears that the company computed the aggregate amount paid to the officers/shareholders as compensation based on its desire to minimize its taxable income, but it is reasonable to anticipate that the IRS will focus on the amount of compensation that is reasonable for each of the four compensated individuals.

The Rabys’ example gives us only aggregate information, so let’s add some facts. Let’s suppose that the treasurer and secretary each received \$200,000, the sales vice president received \$400,000, and the CEO received \$1.7 million. It is possible that, in an examination, the IRS will look separately at each individual’s compensation, and it is also possible that the IRS will focus on the aggregate compensation. The company itself has no audit experience, but an outside tax adviser may be able to shed some light on the likely approach. Based on my own discussions with CPAs, it is my impression that auditors are not likely to object to the choice of a unit of account for which there is a reasonable basis. Therefore, the company may wish to apply Step 2 and Step 3 tentatively to both the overall officer-compensation deduction and

the individual compensation deductions and then select its units of account based on the approach that yields the better result.⁴

Step 2: Determine whether it is MLTN that the position would be sustained in litigation. Once the unit of account is chosen, the company must apply the MLTN recognition standard to the company’s tax position. Interestingly, identifying the company’s tax position involves another judgment for the company. Let’s suppose the chosen unit of account is the overall officer-compensation deduction. What is the company’s “tax position” with respect to that item?

At first blush, it appears that the company’s position is that \$2.5 million of officer compensation is deductible. If that is correct, the company may not recognize *any* of the benefit from the deduction unless it concludes that a court would MLTN sustain the entire deduction. However, it does not appear that FASB intends companies to interpret the term “tax position” in such a restrictive manner. Another example in FIN 48 comes into play here. In paragraphs A5-A7, FIN 48 presents an example in which a company claims \$250,000 of research and experimentation credits for each of several research projects and “believes it is more likely than not that the enterprise will ultimately sustain a benefit” of approximately \$200,000 per project. Based on no additional facts, the example says that the company determines it meets the MLTN recognition threshold for each of the projects. Although the example may be interpreted in more than one way, it strongly suggests that the company is not required to have determined that a court would MLTN sustain 100 percent of the claimed credits.

Thus, in the Rabys’ example, it is plausible to conclude that, for purposes of applying the MLTN recognition threshold, the company’s tax position is that “some of the compensation paid to the officers/directors is deductible” or “some of the compensation paid to each officer/director is deductible,” depending on the chosen unit of account.⁵

Step 3: Determine the largest tax benefit that is MLTN to be realized on ultimate settlement with the taxing authority. This is by far the most difficult step in the FIN 48 process, and the examples in FIN 48 do not provide useful guidance. The Rabys acknowledge this, writing:

Like the FASB illustration of a calculation at para. A-23 of FIN 48, our example above is grossly oversimplified. What are the possible outcomes?

³In fairness to the Rabys (whose illustrative analysis I do not intend to criticize), an example in FIN 48 itself suggests that the separate steps may be conflated. Paragraph A26 in FIN 48 sets forth a confusing example in which a company that has expensed the cost of what is probably an asset amortizable over 15 years simply determines that the largest deduction that is MLTN to be sustained is $\frac{1}{15}$ of the amount claimed, with no explanation of what the company’s “tax position” is or how the company determined that the position crossed the MLTN threshold for recognition.

⁴In that particular example, it does not appear that the choice of a unit of account will affect the FIN 48 outcome. That is because, as shown below, the company will likely conclude that its tax position(s) satisfy the MLTN recognition threshold regardless of whether the unit of account is the overall compensation deduction or each individual compensation deduction.

⁵Of course, it is critical that the company’s auditors agree that this characterization of the company’s “tax position” is appropriate. The company’s tax counsel should be prepared to discuss with the auditors — in advance of preparation of the company’s financial statement — why the characterization is appropriate. To do that effectively, counsel must understand the nuances of FIN 48.

We do not think it sufficient to merely come up with an array of numbers and probabilities that are not backed up by detail.

Now let's go back to the real world. The company in the Rabys' example does not have audit or tax litigation experience, but it has engaged outside tax counsel with that experience, and the company's measurement will be based on tax counsel's evaluation of possible outcomes. I believe that no part of tax counsel's evaluation would look anything like the items in the Rabys' table. If I were engaged by the company, my evaluation certainly would not. For example, in assessing the likely outcome of a settlement at the examination level, I cannot imagine saying, "There is a 32 percent chance that the agent will allow a \$1.3 million deduction," or, "There is a 32 percent chance that the company will settle with the agent for \$1.3 million." Rather, if the facts justified it, I would be more likely to say something like the following:

It is MLTN that the agent will allow \$75,000 for the secretary, \$75,000 for the treasurer, and \$200,000 for the sales vice president, even if you litigate the deduction for the CEO. It's unlikely that the agent will allow more than half of the CEO's compensation (\$850,000), but I think it's MLTN that you can get that much. Thus, I think it's MLTN that you can settle with the agent for \$1.2 million (\$75,000 + \$75,000 + \$200,000 + \$850,000).⁶

I don't think we can get more than \$75,000 for either the secretary or the treasurer in litigation, but if we settle those two at the examination level and have a clean litigation limited to the sales vice president and the CEO, I think we have a good chance of getting the entire deduction for those two officers.⁷ So, if you're willing to go to court on the two highly paid officers, I think we have a MLTN chance of getting a total of \$150,000 from the agent and \$2.1 million from litigation, for a total of \$2.25 million.

However, if you're not willing to go to court (and I can't guarantee that we would do that well in court), we should consider our chances in appeals. I still don't think we'd do better than \$75,000 for either the secretary or the treasurer, but I think we could get the full \$400,000 for the sales vice president as long as we take a reasonable haircut on the CEO. Even though you have good facts supporting the CEO's compensation, the appeals officer is probably going to believe that a court would knock the deduction down by one third, so it's going to be very difficult to settle in appeals without giving up

around \$600,000. My overall judgment is that we are MLTN to get appeals to agree to a total deduction for all four officers of approximately \$1.65 million (\$75,000 + \$75,000 + \$400,000 + \$1.1 million).

Based on that advice, the amount the company should book as a FIN 48 liability depends on whether the company is willing to litigate the compensation issue. If the company is risk-averse or has other reasons for not wanting to litigate, counsel can provide reasoned support for a FIN 48 liability based on the loss of \$850,000 of deductions (\$2.5 million - \$1.65 million). However, if the company is willing to litigate, counsel can provide reasoned support for a FIN 48 liability based on the loss of only \$250,000 of deductions (\$2.5 million - \$2.25 million). That dramatic difference exists because the measurement of recognized tax benefits under FIN 48 takes into account all facts and circumstances, including the company's own willingness to settle.⁸

As the Rabys expressly acknowledge, the example in their article is grossly oversimplified. Even with the facts I have added, the example is oversimplified, but those additional facts allow us to walk step by step through the recognition/measurement process mandated by FIN 48. Examining the separate steps reveals that there are multiple points at which companies must make judgments that will affect the FIN 48 outcome and that tax counsel must understand the FIN 48 process to give effective advice to a company with audited financial statements.

⁸See FIN 48, paragraph A23. ("After considering all relevant information, management's confidence in the technical merits of the tax position exceeds the more-likely-than-not recognition threshold, but *management also believes it is likely it would settle for less than the full amount of the entire position when examined*" (emphasis added).)

⁶I am assuming here that all four individuals work for the company on a full-time basis and that there is factual support for the conclusions described in this paragraph.

⁷Again, I am assuming that there is factual support for the stated conclusion. Note that the purpose of this exercise is not to illustrate how to advise a client when handling a reasonable compensation case. Rather, the purpose is to illustrate how the evaluation of a tax controversy by tax counsel affects the FIN 48 treatment of the tax benefits involved.