Accounting for Uncertainty in Income Taxes — The Effect of FASB Interpretation No. 48

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Every chief financial officer, chief tax officer, and general counsel — as well as every other person with responsibility for a company’s financial statements — should be conversant with final Interpretation No. 48 (FIN 48), which was issued by the Financial Accounting Standards Board on July 13, 2006. FIN 48 provides definitive guidance on how to address uncertainty in accounting for income tax assets and liabilities under FASB Statement No. 109, Accounting for Income Taxes. As the Board stated in its July 13 press release, FIN 48 “prescribes a consistent recognition threshold and measurement attribute, as well as clear criteria for subsequently recognizing, derecognizing and measuring such . . . positions for financial statement purposes. The Interpretation also requires expanded disclosure with respect to the uncertainty in income taxes.”

This article summarizes significant features of FIN 48, with an emphasis on how FIN 48 will affect the responsibilities of corporate tax departments.

**Background**

FAS 109 describes the objective of accounting for income taxes as recognizing “(a) the amount of taxes payable or refundable for the current year and (b) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise’s financial statements or tax returns.”1 FAS 109 also recognizes the following four “basic principles of accounting for income taxes”:

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

b. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.

c. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.

d. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.2

FAS 109 provides no guidance, however, on how to take uncertainties into account when determining “estimated taxes” and “estimated future tax effects.” Owing to this lack of guidance, the FASB has observed that “diverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes. This diversity in practice has resulted in noncomparability in reporting income tax assets and liabilities.”3

On July 14, 2005, the FASB published an exposure draft containing a proposed interpretation of FAS 109. Under the proposed interpretation, a company would not have been permitted to recognize the benefit from a tax return position without making an affirmative determination that it was “probable” that the position would be sustained on the merits. Following significant public comment, in November 2005 the FASB decided to lower the standard for recognition from “probable” to “more likely than not.”4 FIN 48 reflects that decision and other responses to public input and clarifies certain points that were ambiguous in the proposed interpretation.

**Scope of Application**

FIN 48 applies to all companies that account for tax positions in accordance with FAS 109 — i.e., any company with audited financial statements — including pass-through entities and nonprofit organizations if they are subject to tax. (¶ 1)5 It applies to state, local, and foreign income taxes as well as federal income taxes. As a technical matter, it applies to all tax positions, regardless of whether they are “uncertain.” (¶ 4, ¶ B10-12)

FIN 48 does state, however, that the Board “does not anticipate that this Interpretation will have a significant effect on how enterprises account for tax positions that are routine business transactions that are clearly more likely than not of being sustained at their full amounts upon examination.” (¶ B12) As a practical matter, FIN 48 is likely to affect the functioning of the tax department only with respect to tax positions that involve significant uncertainty.

**Effective Date and Transition**

FIN 48 is mandatory for a company’s first fiscal year beginning after December 15, 2006. (¶ 22) The first financial statement in which FIN 48 is adopted must apply the principles of FIN 48 to all tax positions, including tax positions taken on returns for prior periods. (¶ 23) The effect of applying FIN 48 to prior-period positions must be reported in the financial statement as an adjustment to the opening balance of retained earnings. (¶ 23) The need to apply FIN 48 to prior-period positions may compel the tax department to revisit past transactions and reporting decisions using new analytical tools.

**The More-Likely-Than-Not Recognition Standard**

In order to report the benefit of a tax position on a company’s generally financial statement, the company generally must determine that it is more likely than not that the position will be sustained, based on the technical merits of the position, if the taxing authority examines the position and the dispute is litigated to the court of last resort. (¶ 7, ¶ A2) The determination is made on the basis of all the facts,
circumstances, and information available as of the reporting date.

In a departure from the foregoing requirement of an “on the merits” determination, FIN 48 states that companies may take administrative practices of taxing authorities into account (in addition to legal authorities) as long as those practices are “widely understood.” (¶ 7(c), ¶¶ A12-A15) The Minutes of the FASB’s May 10, 2006, meeting provide that the “administrative practices” concept generally is “intended to deal with a limited number of tax positions that are technical violations of the tax law for which it is broadly understood that the taxing authorities, with access to all relevant facts, would not object.”

One example provided by FIN 48 involves a taxing authority’s practice of not objecting to a capitalization threshold (i.e., a company’s practice of expensing all items purchased for less than $x). (¶¶ A12-13) Another example provided by FIN 48 involves a company that has been doing business in two jurisdictions for 50 years and 20 years, respectively, and has filed tax returns with those jurisdictions for each of those years. (¶¶ A14-15) Although the company is not certain that it was not doing business in those jurisdictions before the years in which it filed returns, and although the statutes of limitations do not begin to run until returns are filed, it is a widely understood administrative practice of one of those jurisdictions (Jurisdiction B) to look back only six years in examining open years. The example does not provide an express conclusion, but it suggests that the company may properly conclude that it is more likely than not that a return is not required to be filed in Jurisdiction B for any open year. No such conclusion is justified, however, for the other jurisdiction.

In applying the more-likely-than-not standard to a tax position, a company must assume that the position will be examined by the relevant taxing authority and that the authority will have knowledge of all relevant facts. (¶ 7(a))

FIN 48 does not require that a company obtain a tax opinion from outside counsel in order to establish that the more-likely-than-not recognition standard has been satisfied. When a tax position involves technical complexity or significant uncertainty, however, a tax opinion may be the best evidence supporting the company’s decision to recognize a tax benefit. In this regard, FIN 48 states:

The Board believes that a tax opinion can be external evidence supporting a management assertion and that management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law. Other evidence, in addition to or instead of a tax opinion, supporting the assertion also could be obtained; the level of evidence that is necessary and appropriate is a matter of judgment that depends on all available information. (¶ B34)

The more-likely-than-not threshold for recognition under FIN 48 coincides with (1) the confidence level required by section 6664(d)(2)(C) of the Internal Revenue Code under the “reasonable cause” exception to the reportable transaction penalty under section 6662A and (2) the comfort level that, under IRS Circular 230 (relating to “practice before the IRS”), may cause a tax opinion to be considered a “reliance opinion.” (Circular 230, § 10.35(b)(4)(i)) Circular 230 requires rigorous due-diligence and opinion-drafting procedures. The full panoply of these procedures generally is not required by the Internal Revenue Service where an opinion that (1) is prepared solely to evaluate the merits of a position taken on an already-filed return (Circular 230, § 10.35(b)(2)(ii)(C)), or (2) is not intended to be used by the company for the purpose of avoiding potential tax penalties and contains appropriate disclaimer language to that effect (Circular 230, § 10.35(b)(4)(iii)). Many tax counsel believe, however, that a significant subset of those procedures is required in appropriate cases as a matter of sound legal practice. Moreover, auditors may question the value of an opinion supporting recognition of a tax position if the Circular 230 Procedures are not followed. Accordingly, when requesting an opinion from counsel, a company should consider advance discussions both with counsel and with the company’s auditors on the procedures to be followed by counsel in preparing the opinion.

A company’s auditors will generally expect to review opinions supporting the company’s tax positions, but the auditors will be unable to prepare such opinions absent audit-committee approval in accordance with Sarbanes-Oxley protocols.

**If The More-Likely-Than-Not Recognition Standard Is Not Satisfied**

If a company determines that it is not more likely than not that a tax benefit reported on its return would be sustained on audit, it may not report any benefit from the tax position on its financial statement unless and until such time as (a) the facts and circumstances (or law) change so that the tax position achieves more-likely-than-not status, (b) the position is favorably resolved after examination by the taxing authority, or (c) the statute of limitations for the taxing authority to challenge the position expires. (¶ 10(c))

**If The More-Likely-Than-Not Recognition Standard Is Satisfied — Measuring the Benefit**

If a company determines that a tax position satisfies the more-likely-than-not standard, the company must measure the amount of the benefit to be recognized in its financial statements. It must do this by determining the largest amount of the tax benefit from the position that has more than a 50-percent likelihood of being realized after examination and, where dispute and compromise are likely, ultimate settlement with the taxing authority. (¶ 8)

Determining the probability of realizing a particular amount of a reported tax benefit involves an assessment of matters such as management’s willingness to settle for less than the reported benefit and the company’s settlement experience with the taxing authority in examinations of similar positions. (¶¶ 23-24)

FIN 48 contains an example in which a company claiming a $100 tax benefit on its tax return measures the amount of the benefit to recognize in its financial statement by determining the individual probabilities that, after examination, it will realize $100, $80, $60, $50, $40, $20, and $0 of the benefit, respectively. (¶¶ A21-22) Those probabilities are 5 percent, 25 percent, 25 percent, 20 percent, 10 percent, 10 percent, and 0 percent. The company also determines that the “cumulative probability” of each outcome is the sum of the individual
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probabilities of (1) that outcome and (2) the outcomes in which greater benefits are realized. In the example, the company recognizes $60 of the benefit in its financial statement, because the sum of the probabilities that it will recognize $100 (5%), $80 (25%), and $60 (25%), respectively (i.e., the cumulative probability that it will realize $60), is greater than 50 percent, while the sum of the probabilities that it will recognize $100 (5%) and $80 (25%), respectively (i.e., the cumulative probability that it will realize $80), is not greater than 50 percent.

There is an element of extraordinary artificiality in this example. It is difficult to imagine, in practice, determining individual probabilities for particular outcomes in any rational manner. It is even more difficult to imagine determining individual probabilities for particular outcomes in a manner that permits those probabilities to be aggregated to a total of 100 percent.

In any event, notwithstanding the example in paragraphs A21-22, there does not appear to be any requirement in FIN 48 that a company’s measurement process involve adding the individual probabilities of separately handicapped outcomes. It should be acceptable for management to reach the same conclusion as the company in the example based on (1) a determination that the company would be willing to settle the item for $60 or more and (2) an informed determination that $60 is the highest amount that the taxing authority would more likely than not agree to in settlement negotiations. If a company measures the likely outcome of settlement discussions using a “hazards of litigation” analysis that involves, for example, (1) the company’s own risk assessment and (2) a prediction of the taxing authority’s risk assessment, this is the kind of analysis that the company will likely apply.

Where a disputed tax position may be resolved under one of multiple alternative (i.e., mutually exclusive) legal theories, and each theory entails a different dollar outcome, the hazards-of-litigation approach may be inappropriate (and there certainly will be no conceptual justification for cumulating the individual probabilities that each of the theories will be agreed to by the taxing authority and used as a basis for settlement). In such a case, if the company is willing to compromise the issue, the recognized benefit should be based on the most favorable settlement that would result from adoption of a theory that has more than a 50-percent likelihood of being accepted by the taxing authority. Interestingly, if a company believes that the taxing authority will not accept or compromise a position and that the resulting dispute will be resolved through winner-take-all litigation, FIN 48 appears to require the company to recognize the entire benefit from the position. This is because, under such circumstances, there is no outcome other than 100-percent realization that has more than a 50 percent likelihood of occurrence. (Since the company has determined that the position satisfies the more-likely-than-not recognition threshold, the company has already concluded that there is more than a 50-percent likelihood of prevailing in litigation. Since the taxing authority will not compromise, the likelihood of realizing an amount of the benefits that is less than 100 percent is zero.)

Classification of Unrecognized Tax Benefits

If less than 100 percent of the benefit from a tax position is recognized, the difference will give rise to a liability, a reduction of a tax refund receivable, a reduction of a deferred tax asset, or an increase in a deferred tax liability. Any liability arising from the excess of a tax benefit claimed on the tax return over the amount recognized in the company’s financial statement should be classified as a current liability for any amount that is anticipated to be paid within one year (or the operating cycle, if longer). (¶ 17) Otherwise, it should be classified as a noncurrent liability. (See ¶ A11)

If the tax position relates to a timing item (i.e., the claimed tax benefit, if disallowed, would give rise to a deferred tax asset), a liability must be recognized for the unrecognized tax benefit, but this FIN 48 liability will be offset by an increase to the corresponding deferred tax asset. (¶ A11) In other words, giving effect to FIN 48 with respect to timing items will not affect the balance sheet (except as to the recognition of interest and penalties), but may nonetheless require changes in accounting for unrecognized tax benefits from such items.

Subsequent Recognition, Derecognition, and Changes in Measurement

If a company has not reported the benefit of a reported tax position because the position has not previously met the more-likely-than-not standard, but circumstances have changed so that the position now meets that standard, the tax benefit must be recognized in the company’s financial statement for the period in which the change in circumstances occurs. (¶ 10) Similarly, if the benefit of a tax position was previously recognized in the financial statements because the position met the more-likely-than-not standard, but circumstances have changed so that the position no longer meets that standard, the company must “derecognize” the tax benefit in the period in which the change in circumstances occurs. (¶ 11) A similar principle applies where changed circumstances cause a change in the company’s measurement of the amount of a recognized tax benefit. (¶ 12)

FIN 48 states that a subsequent recognition, derecognition, or change in measurement “should result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.” (¶ 12) The use of the term “should” rather than “shall” suggests that the stated principle is not absolute, but no guidance is given on appropriate departures from normal application of the principle. Also, there is ambiguity in the term “new information.” Clearly, in appropriate circumstances, communications from a taxing authority about its settlement position with respect to a disputed position may be considered “new information.” Not so clearly, “new information” also may include an opinion from outside counsel that is contrary to a legal analysis previously adopted by the company. Notably, the paragraph in FIN 48 governing this point refers to “facts, circumstances, and information,” implying that “information” is not coextensive with “facts.”

In sum, if a company no longer agrees with its prior evaluation of unchanged facts and circumstances that led to (1) its prior-period decision to recognize or not recognize a tax benefit in a financial statement for a previous period, or (2) its prior-period measurement of a recognized tax benefit, the company may properly conclude that the reevaluation is not based on new information and that the company should not report any current-period change based on the reevaluation. It is not clear, however, whether the company also may properly choose to report the effects of the reevaluation if the reevaluation is based on new inputs such as third-party tax advice.

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THE TAX EXECUTIVE
Interest and Penalties

A. Interest
If interest would be payable on an underpayment of tax, a company must recognize interest expense in its financial statement for each period during which the interest accrues under the applicable tax law, based on the difference between the amount of the tax benefit recognized in the company’s financial statement and the amount claimed on its tax return. (¶ 15) Thus, if the company cannot conclude that it is more likely than not that a tax position will be sustained, and the company therefore does not recognize any of the claimed benefit in its financial statement, it must recognize the full amount of the interest expense that would result from complete disallowance of its tax-return position. On the other hand, if the company recognizes 60 percent of a claimed benefit in its financial statement, it must recognize interest expense equal to the statutory interest rate on tax deficiencies multiplied by 40 percent of the claimed benefit.

B. Penalties
If a tax position does not meet the minimum statutory threshold to avoid penalties, a company must recognize an expense equal to the amount of the statutory penalty for the period in which the company recognizes the benefits of the position. (¶ 16)

Disclosure of Unrecognized Tax Benefits
FIN 48 requires a company to include the following disclosures at the end of each annual reporting period (¶ 21):

- A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, including (1) the gross amounts of the increases and decreases in unrecognized tax benefits attributable to of tax positions taken during a prior period, (2) the gross amounts of increases and decreases in unrecognized tax benefits attributable to tax positions taken during the current period, (3) the amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities, and (4) reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

- In the case of positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date, (1) the nature of the uncertainty, (2) the nature of the event that could occur in the next 12 months that would cause the change, and (3) an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.

- A description of tax years that remain subject to examination by major tax jurisdictions.

The required tabular reconciliation is a presentation of aggregated information relating to the FIN 48 liability. Companies are not required to disclose information about individual unrecognized (or partially recognized) tax positions. Where there are significant changes in the total amount of unrecognized tax benefits between the beginning and end of a reporting period, however, companies may, as a matter of investor relations, choose to provide some narrative detail. In addition, since the disclosed FIN 48 liability may include amounts that are offset by increases in deferred tax assets, companies may wish to include narrative explanations of the timing effect of the liability.

During deliberations regarding the disclosure requirements, some members of the FASB expressed a concern that the required disclosures could provide a “roadmap” to taxing authorities, particularly taxing authorities in foreign jurisdictions that do not have access to Schedule M-3 on the U.S. corporate tax return. (See minutes of the FASB’s May 10, 2006, meeting.) The Board rejected this concern, in part because it does not think that the required disclosures will “reveal information about individual tax positions,” and in part because it considers taxing authorities to be “acting in the broader public interest in regulating compliance with self-reporting income tax laws.” (¶ B64)

Effect on Tax Departments
Under the FIN 48 regime, tax departments will need to implement processes to handle the following matters on an ongoing basis:

- Since management will need to justify its decisions to recognize benefits from tax positions under the recognition standard and measurement principles of FIN 48, tax departments will need to (1) adopt procedures for determining the “unit of account” (i.e., the appropriate level of disaggregation) for analyzing tax positions, (2) adopt procedures for identifying tax positions with sufficient uncertainty to warrant a full-fledged FIN 48 analysis, (3) document the analysis warranting each determination that a particular uncertain position is more likely than not to be sustained, (4) document the methodology applied to measure the recognized benefit from each uncertain tax position, and (5) document the methodology used to calculate interest expense with respect to each unrecognized tax benefit.

- Since changes in circumstances may necessitate recognition, derecognition, or remeasurement of benefits from tax positions taken in prior-period returns, tax departments will need to maintain an inventory of all tax positions with a significant degree of uncertainty (even if the benefits from such positions were fully recognized), except tax positions that are outside the applicable statute of limitations.

- Because FIN 48 may increase the likelihood that tax benefits from transactions will not be recognized, tax departments will want to apply a “FIN 48 filter” to contemplated transactions with significant tax uncertainties so that decisions not to recognize tax benefits do not come as a surprise to management.

In the transition period culminating in the issuance of the first financial statement adopting FIN 48, tax departments will need to inventory all previously reported uncertain tax positions for which the applicable statute of limitations is still open and apply the FIN 48 recognition and measurement analysis to each such position.

The Role of Outside Tax Counsel
The FASB has concluded that “a tax opinion can be external evidence supporting a management assertion and that management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law.” (¶ B34)
Although a tax opinion is not technically required to justify the decision to recognize a tax benefit, there are many circumstances in which an unqualified more-likely-than-not opinion from outside counsel will be valuable to a company’s management and/or its tax department. Under FIN 48, tax departments will need to document a refined decision process for the recognition and measurement of the tax benefits of all tax positions. Where a tax position involves any significant amount of uncertainty, an outside opinion often will be the tax director’s or CFO’s best choice for documenting a decision to recognize all or part of the benefits from the position. Also, where the benefits from a tax position have not previously been recognized, there may be circumstances in which an opinion from outside counsel may constitute “new information” permitting current-period recognition of the benefit.

Investment in legal services to support financial statement recognition of a company’s tax positions will provide dual benefits. In addition to supporting the company’s financial reporting, contemporaneous analysis of uncertain tax positions and written documentation of that analysis will likely reduce the cost of future tax audits.

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2. Id.
5. All “¶” references in this article are to paragraphs of FIN 48.
7. FIN 48 ¶ 8 actually refers to “the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.” (Emphasis added.) Although there is no clear statement that measurement, like recognition, must be based on the assumption that the tax position in question will be examined, the italicized language suggests that this is the FASB’s intent.