FIN 48: are you ready to apply one of the most significant tax accounting developments?

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Title Annotation: *FASB NEWS*
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Date: *May 1, 2007*
Words: *1645*
Publication: *California CPA*
ISSN: *1530-4035*

The validity of a tax position is, in principal, a matter of tax law. It is a generally accepted practice to recognize the benefit of a tax position in financial statements when there is a high degree of confidence that the position will be sustained upon examination by a taxing authority.

In some cases, however, tax law is subject to varied interpretation, giving rise to uncertainty as to whether a tax position will be sustained.

[ILLUSTRATION OMITTED]

FASB Statement No. 109 contains no specific guidance on how to address this uncertainty and, as a result, diversity in practice has developed. In response to this diversity, FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes--an interpretation of FASB Statement No. 109.

FIN 48 was issued in June 2006 and is effective for fiscal years beginning after Dec. 15, 2006. Along with prescribing recognition and measurement criteria for uncertain tax positions, it also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Under FIN 48, there is a two-step process to evaluate uncertain tax positions, which includes positions taken in previously filed returns and positions expected to be taken in returns that will include transactions that are reported currently on the financial statements. Tax positions also include the decision not to file a return, allocation of income between jurisdictions, the characterization of income as non-taxable and the decision to treat an entity or transaction as tax exempt. The first step is recognition and the second is measurement.

RECOGNITION

The benefit of a tax position is recognized if it is deemed more-likely-than-not to be sustained upon examination by a taxing authority. In other words, if it is more than 50 percent likely that the position will be sustained, the benefit of the position can be recognized.

It should be presumed that the tax position will be examined. Each position is assessed separately and not aggregated with others. The assessment is made each reporting period based upon the tax law (including statutes, legislative intent, regulations, rulings and case law) and considers administrative practices and precedents that are widely known. Considerable judgement is required in assessing likelihood of a position being sustained.

If a tax benefit is not recognized because the 50 percent probability threshold is not met, the benefit is recognized in future periods:

* When the 50 percent threshold is met;

* The matter is settled through negotiation or litigation; or

* The statute of limitations has expired.

Although FIN 48 refers to "ultimate settlement" of a position, a recent FASB proposal uses the concept of "effective settlement." Under the proposal, effective settlement means: all examination procedures, including appeals and administrative reviews, are complete; the entity does not intend to appeal or litigate; and it is highly unlikely that the taxing authority would subsequently examine or reexamine any aspects of the position.

MEASUREMENT

The amount of the benefit to be recognized is the greatest amount that is more-likely-than-not of being sustained. Consider the following examples:

Company A has filed a return taking a tax position that is uncertain of being sustained by the taxing authority. The tax position results in tax benefits of $100. In assessing the probability of being sustained, Company A has arrived at the following estimates:

Company A

Possible Outcome	Probability of Occurence	Cumulative Probability
$100	25%	25%
$75	50%	75%
$50	25%	100%

In this example, a tax benefit of $75 would be recognized since it's the greatest amount of benefit that is greater than 50 percent likely to be sustained.

Company B is planning to file a return, taking a tax position that is uncertain of being sustained and has arrived at the following estimates:

Company B

Possible Outcome	Probability of Occurance	Cumulative Probability
$100	25%	25%
$80	25%	50%

$60	25%	75%
$40	25%	100%

In this example, since $60 is the greatest amount of benefit that is greater than 50 percent likely to be sustained, a tax benefit of $60 would be recognized.

If a recognized tax benefit becomes less-likely-than-not of being sustained due to changing assessments of probability, the amount is derecognized. Use of a valuation allowance is not permitted. Instead, the entire benefit is derecognized when the more-likely-than-not criteria is no longer met. However, measurement of the amount of the benefit may change based upon an assessment of new information as explained below.

It should be noted that tax strategies contemplated under Statement 109 to support realization of a deferred tax asset should be subjected to the probability assessments of FIN 48.

SUBSEQUENT ACCOUNTING

In assessing probabilities for either recognition, derecognition or remeasurement at each reporting date, changes from prior judgments should be based on new information and not from a new evaluation or interpretation of previously available information. If changes in the measurement of a tax benefit result from the assessment of new information, such changes are reported as a discrete item in the financial statements of the period in which the change occurs.

INTEREST AND PENALTIES

When the tax law requires interest to be paid on an underpayment of income taxes, interest is recognized at the statutory rate applied to the difference between the tax position recognized and the position taken, or expected to be taken, in the tax return. In addition, if the minimum statutory threshold is met requiring a penalty, the penalty is recognized in the financial statements. Consider the following examples:

Company A (Page 25) has recognized a $75 tax benefit in its financial statements and has filed its return claiming a $100 tax benefit. Assuming a 7 percent statutory rate of interest, Company A would recognize interest at 7 percent on $25 in the first period interest is required to be paid pursuant to applicable tax law. In addition, if an underpayment of $25 would result in a penalty, such penalty should be recognized in the period in which it claims the position on its tax return.

Company B (Page 25) has recognized a $60 tax benefit in its financial statements and plans to file its return claiming a $100 tax benefit. Accordingly, Company B would recognize interest at 7 percent on $40 in the first period interest is required to be paid pursuant to applicable tax law and, if a $40 underpayment of tax results in a penalty, would recognize a penalty as well.

CLASSIFICATION

As a result of applying FIN 48, a company will recognize liabilities, reduced refunds or reduced net operating loss carry-for-wards in addition to the amounts reflected as payable or refundable from the returns filed or to be filed. These liabilities are reflected in the company's balance sheet as current if they are expected to result in a receipt or payment of cash within one year or operating cycle. These amounts are combined with deferred tax assets or liabilities if they arise from a taxable temporary difference as described below.

In applying FIN 48, the tax bases of assets or liabilities may be affected, which will also affect temporary differences and thus the determination of deferred tax assets and liabilities. A liability recognized pursuant to FIN 48 that arises from a taxable temporary difference is classified as a deferred tax liability.

Interest recognized in applying FIN 48 may be reported as either interest expense or income tax expense, and whatever policy is selected should be consistently applied. Similarly, penalties recognized may be reported as either income tax expense or in another expense category.

DISCLOSURE

In addition to disclosing its policies regarding the classification of interest and penalties, a company annually must provide a tabular reconciliation that includes:

* The gross amounts of increases and decreases in unrecognized tax benefits from tax positions taken in prior periods;

* The gross amounts of increases and decreases in unrecognized tax benefits from tax positions taken in the current period;

* Decreases in unrecognized tax benefits resulting from settlements with taxing authorities;

* Decreases in unrecognized tax benefits resulting from a lapse of a statute of limitations; and

* Other amounts necessary to reconcile the total amounts of unrecognized tax benefits as of the beginning of the year to those as of the end of the year.

Other required disclosures include:

* The total amount of unrecognized benefits that, if recognized, would affect the effective tax rate;

* The total amounts of interest and penalties recognized in the statement of operations and in the balance sheet;

* For unrecognized tax benefits for which it is reasonably possible that the amounts will significantly change within 12 months: (1) the nature of the uncertainty; (2) the event that could occur that would cause the change; and (3) an estimate of the range of change or statement that an estimate cannot be made; and

* A description of tax years still subject to examination by major tax jurisdictions.

TRANSITION

In the period FIN 48 is first adopted, the net change in recognized assets and liabilities is reported as a cumulative effect adjustment to the opening balance of retained earnings.

LEARN MORE

FIN 48 is one of the most significant tax accounting developments in a number of years. Although it is intended to increase the comparability of financial statements, it also significantly increases the calculation and documentation requirements for individually identified income tax exposures. Affected companies should further explore FIN 48 to understand what it means for them and implement measures to get them ready for when the new rules are first applied to them.

RELATED ARTICLE: Need More Help?

The AICPA has created a practice guide, Accounting for Uncertain Tax Positions Under FIN 48, which is free i to all members and available at www.aicpa.org/FIN48guide.

The IRS also has made available a FIN 48 FAQ, available at www.irs.gov/businesses/corporations/article/0,,id=163683,00.html.

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