

Financial-Reporting Effects of Uncertain Tax Positions

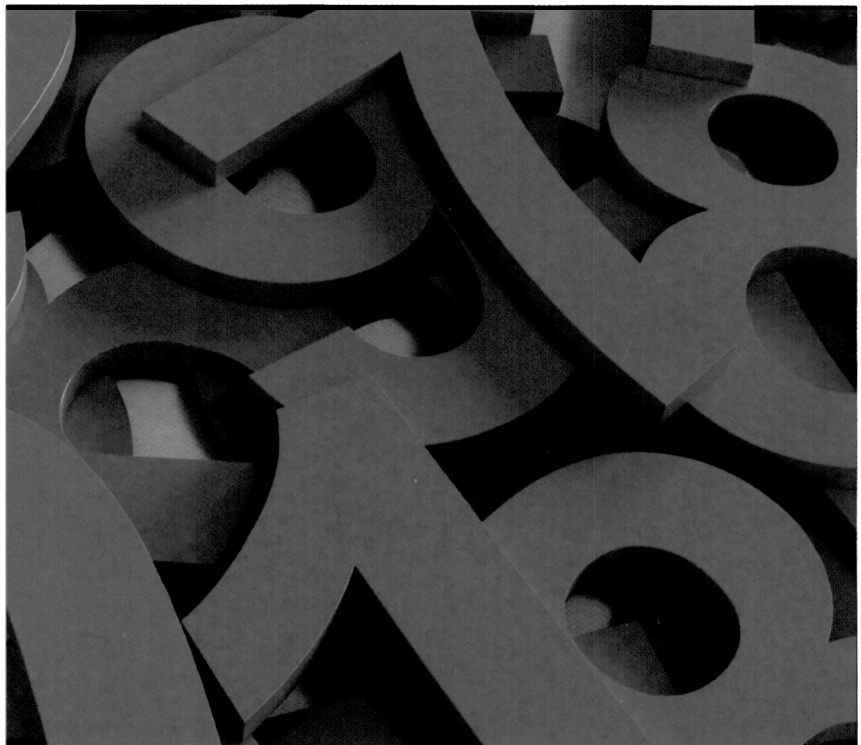
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The Internal Revenue Code's inherent complexity presents challenges when accounting for tax positions whose ultimate resolution may be uncertain. Because income taxes are self-assessed in most tax jurisdictions, a company may take a position on its tax return that allows it to claim a tax benefit minimizing its tax liability. Such a position permits a company to realize a current cash flow in terms of reduced income taxes but creates a potential cash outflow if the tax position is subsequently reviewed by the IRS. The validity of the tax position is a matter of tax law, and due to the volume and complexity of tax laws, related regulations, and legal interpretations, the ultimate resolution, if challenged by the IRS, must often be considered uncertain.

Because SFAS 109, *Accounting for Income Taxes* (1992), does not currently prescribe a confidence threshold that must be met for benefits from a tax position to be recognized, considerable diversity has developed in practice. Many companies will record the tax benefits on an "as-filed" basis. That is, any current or deferred tax assets or liabilities are immediately recognized when the related tax position is taken. A valuation allowance is frequently recorded to reduce any current or deferred tax benefit if it is "more likely than not" an adjustment will be required. Such amounts can be significant, and their resolution often takes years. For example, in its 2005 annual report, Microsoft reported an adjustment of \$776 million to its 2005 tax provision due to the resolution of tax matters related to the 1997–1999 tax years. Other companies employ other methods to recognize such benefits (e.g., gain contingency accounting and accrual of amounts based on a predetermined threshold of whether

the position will be sustained on audit). The various alternative approaches to recognizing the tax benefits associated with uncertain tax positions have reduced comparability in the financial reporting of income taxes.

In response, FASB issued Interpretation (FIN) 48, *Accounting for Uncertainty in Income Taxes*. It contains guidance on the recognition and measurement of all tax positions accounted for in accordance with SFAS 109. Specifically, Interpretation 48



Financial Executives International (FEI; www.fei.org) listed accounting for uncertain tax positions as one of the top 10 financial reporting challenges for 2006. The financial reporting implications related to uncertain tax positions have also drawn the scrutiny of the SEC. In several speeches, SEC staff have clearly expressed their view that companies should not recognize any tax benefit unless it was probable that the tax position would be accepted by the IRS and that adequate disclosure of uncertain positions should be made.

advocates an asset (tax benefit) recognition model that uses a two-step approach: 1) A tax benefit is recognized in the financial statements only if the tax position is more likely than not to be sustained based on its technical merits. 2) If the tax position qualifies for recognition, the tax benefit should be measured as the largest amount of benefit cumulatively greater than 50% likely to be realized.

This interpretation is effective for fiscal years beginning after December 15, 2006. By establishing consistent thresholds for

recognition and measurement of tax benefits, the diversity in current practice should be reduced and the relevance and comparability of the financial reporting related to income taxes should be improved.

Step 1: Initial Recognition

The initial recognition of an uncertain tax position should be based on whether, given the technical merits, it is more likely than not to be sustained on audit, which includes the various methods to settle tax disputes (e.g., resolution of litigation). Three items of particular concern at initial recognition are the appropriate unit of account, the probability of the tax position being audited, and the threshold at which recognition should occur.

First, in identifying uncertain tax positions, a company must determine the appropriate unit of account, or level of disaggregation, with respect to the tax positions taken in the tax return. For example, is the entire research and experimentation (R&E) credit the appropriate unit of account to be analyzed, or should the analysis be conducted at the individual project or the cost level? Under FIN 48, the appropriate unit of account is a matter of judgment, and companies should consider the manner in which they prepare and support their returns, and their past experiences with the taxing authorities.

Second, FIN 48 presumes that uncertain tax positions will be audited, which effectively removes detection risk from consideration. A company cannot simply presume the tax position will be accepted due to the low probability of being audited. Conceptually, tax liabilities should be recognized when the obligating event—the generation of taxable income—occurs. While such a position may overstate a company's liabilities and future cash flows, FASB believes that presuming the position will be evaluated by the taxing authority enhances consistency in assessing the tax position and provides users with a better understanding of the risks associated with uncertain tax positions.

Finally, FIN 48 employs a recognition threshold of more likely than not that the tax position will be sustained on audit, where more likely than not represents a probability assessment of greater than 50%. The determination of whether this threshold has been met should be made based on

the available information at the reporting date. Such available information should include all relevant legislation, regulations, rulings, and case law, as well as past administrative practices and precedents of the taxing authority.

From a practical standpoint, the adoption of the more likely than not threshold should result in a decrease in the tax benefits recognized on the financial statements. Treasury Department Circular 230 requires that a tax position have a realistic possibility—defined as a one-in-three-or-greater likelihood—of being sustained on its merits, to be signed by the tax preparer. To the extent that the likelihood of the tax position being sustained would fall between the realistic possibility standard and the more-likely-than-not threshold, a company would no longer recognize the benefits of the tax position in its financial statements. This could adversely impact debt ratios, increase interest expense, and increase a company's effective tax rate.

Step 2: Measurement

If the tax position does not meet the recognition threshold, no benefit can be recognized. Assuming that a tax position meets the recognition criteria, the second step is to measure the tax benefit, defined as the largest amount that is more likely than not to be realized.

Initially, FASB proposed a "best estimate" approach, which was defined as

the single most likely amount in a range of outcomes—similar to the statistical mode of a distribution. This best-estimate approach was controversial: The use of a single-point estimate in situations with a wide range of low-probability outcomes could result in a misleading and counterintuitive measurement.

For example, assume that a company takes a tax position resulting in a tax benefit of \$100. *Exhibit 1* shows management's assessment of the distribution of possible outcomes. A best-estimate approach would yield the amount of \$100. It is counterintuitive, however, to record a \$100 tax benefit that has a cumulative probability of occurrence (12%) less than the more-likely-than-not threshold (50%).

In FIN 48, FASB ultimately chose to adopt a cumulative-probability approach that would eliminate all outcomes that do not meet the more-likely-than-not threshold. The tax benefit is measured at the largest amount cumulatively greater than the more-likely-than-not threshold (greater than 50%). In this example, it would be \$60.

FASB also explored a probability-weighted or expected-outcome approach. It has been argued that it would more closely reflect economic reality and thus improve the quality of financial reporting. It would have been appealing to some because of its similarity to the approach being considered by the IASB. But due to implementation difficulties, it was disregarded, and

EXHIBIT 1
Measuring the Tax Benefit

Dollar amount of tax benefit that management anticipates will be sustained	Probability the tax position will be sustained	the tax position will be sustained
\$100	12%	12%
90	10	22
80	11	33
70	11	44
60	10	54
50	9	63
40	10	73
30	9	82
20	11	93
10	7	100

FASB chose to address uncertainty using a recognition threshold as described above.

Many companies currently recognize tax benefits on an as-filed basis, effectively capturing 100% of the tax benefit (less any possible valuation allowance) in the financial statements. FIN 48 does not allow a company to recognize the tax benefit related to uncertain tax positions in full

Because these disclosure requirements are more extensive than before, some companies may choose to be less aggressive in their tax positions to avoid confrontations with taxing authorities.

with an offsetting valuation allowance. Applying the measurement criteria in FIN 48 is expected to result in a smaller amount of tax benefit being recognized in the financial statements than is recognized on an as-filed basis.

Subsequent Accounting and Other Issues

Subsequent accounting. The assessment of a tax position under FIN 48 is a continuous process that requires reassessment of each tax position at the reporting date. If new information (e.g., changes in case law, new regulations) causes a tax position taken in a prior year to cross the recognition threshold or changes the measurement of a recognized tax position, the company should reflect the change as a discrete event in the period when the change occurs. A change in judgment relating to a tax position taken during the current year should be reflected in the effective tax rate. It is critical to note that subsequent accounting does not depend upon absolute certainty or final resolution of the

tax matter. If a previously recognized tax benefit no longer meets the more-likely-than-not recognition threshold, a company must derecognize the benefit by recording an income tax liability or reducing a deferred tax asset; the use of a valuation allowance is not appropriate for derecognition. Furthermore, interim reporting of the financial statement effects of such a change in judgment should follow the guidance in APB Opinion 28, *Interim Financial Reporting*, and FIN 18, *Accounting for Income Taxes in Interim Periods*.

Interest and penalties. FIN 48 requires a company to accrue interest and penalties when there is underpayment of taxes, based on management’s best estimate of the amount ultimately to be paid (not considering detection risk) in the same period that 1) the interest would begin accruing or 2) the penalties would first be assessed. The classification of interest (as interest expense or part of the income tax line item) and penalties (as part of the income tax line item or another expense classification) is an accounting policy election that should be consistently applied.

Classification. The difference between the tax benefit recognized in the financial statements and the tax benefit reflected in a tax return should be classified as either:

- A current or noncurrent liability, based on the timing of the related cash flows;
- An increase in a deferred tax liability, if the difference relates to a taxable temporary difference that meets the recognition threshold; or
- A decrease in a deferred tax asset, if the difference is due to a deductible temporary difference.

Disclosures. Disclosures involving tax positions are often highly sensitive. While investors may desire more information,

many companies are concerned about providing taxing authorities with a roadmap to aid their examination of the company’s tax return and, if the issue results in litigation, providing plaintiff’s attorneys with information damaging to the company’s defense. To address these concerns, FIN 48 requires a company to disclose:

- A tabular reconciliation of the beginning and ending balances of unrecognized tax benefits;
- The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate;
- The total amount of interest and penalties recognized in the financial statements;
- A description of tax years that remain subject to examination by major tax jurisdictions; and
- A discussion of the tax positions that management believes are reasonably possible to change significantly within the next 12 months.

FASB hopes these disclosures will provide useful information to users of financial statements without significantly increasing a company’s risk exposure to tax enforcement efforts. Because these disclosure requirements are more extensive than before, some companies may choose to be less aggressive in their tax positions to avoid confrontations with taxing authorities.

Example

To illustrate the accounting for uncertain tax positions, assume that a company claims on its tax return an R&E tax credit equal to \$1 million. Historically, the IRS has challenged whether some of the expenditures meet the definition of “qualified research expenses” under IRC section 41. Before the company can recognize the

EXHIBIT 2 Example: Distribution of Outcomes		
Dollar amount of tax benefit that management anticipates will be sustained	Probability the position will be sustained	Cumulative probability the position will be sustained
\$1,000,000	30%	30%
910,000	30	60
850,000	40	100



tax benefit, it must first determine if the tax position is more likely than not to be sustained on audit. Based on the technical merits of the position, the company believes that all of the expenditures are valid and supportable, and that the majority of them will be sustained on audit. The company has met the recognition threshold and must now determine the amount of the benefit to recognize.

The company estimates the probability distribution of possible outcomes as shown in Exhibit 2. While there is greater probability (40%) that the ultimate tax benefit will be \$850,000, FIN 48 requires the company to recognize a current tax benefit of \$910,000—the largest amount above the more-likely-than-not threshold. The \$90,000 difference between the tax credit claimed on the tax return and the amount estimated to be ultimately sustained should be recorded as a noncurrent liability, because the company does not expect it to be settled within the next year. Additionally, the company should accrue taxes and penalties, if applicable, on the \$90,000 at the applicable statutory rate. The ultimate settlement, at an amount greater or less than \$90,000, would be accounted for in the period of settlement.

Implications

FASB issued FIN 48 to address the significant diversity in accounting for uncertain tax positions. FIN 48 specifies a two-step process in which the company first must determine the likelihood of sustaining an uncertain tax position, assuming a review by the taxing authority. If the position is more likely than not to be sustained, the company must recognize the largest amount that is more likely than not to be realized in its financial statements. If the position fails to meet the more-likely-than-not threshold, the company must increase current tax expense and either: 1) increase its tax liability (or decrease its tax refund receivable); or 2) increase a deferred tax liability (decrease a deferred tax asset). The overall impact of FIN 48 is that, on average, a smaller amount of tax benefit will be recognized in companies' financial statements in the current period.

FIN 48 will most certainly increase the workload on income tax accounting departments while presenting unique challenges for multinational corporations subject to

multiple tax jurisdictions. Companies will need to identify significant tax positions and differentiate uncertain positions from unambiguous ones that would not require FIN 48 analysis. In addition to identifying such tax positions, companies will have to track them and maintain controls to ensure that any future tax positions are identified and evaluated. The process and the controls should also be well documented to comply with section 404 of the Sarbanes-Oxley Act. Not only must the positions be identified, but companies must carefully document their analysis and conclusions regarding the tax position taken

and the dollar amount of the benefits recognized. Finally, auditors should carefully evaluate the supporting documentation, assumptions, and arguments to ensure the accounting for the tax position complies with FIN 48. □

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