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This is a five-part series of articles by Fred F. Murray of Grant Thornton LLP regarding the coming application to nonpublic entities of FASB Interpretation No. 48—Accounting for Uncertainty in Income Taxes, An Interpretation of FASB Statement No. 109.

The first article looks at lessons that can be drawn from public companies' filings under FIN 48. Future articles will examine the operation of the new rules when applied to private entities, the impact of FIN 48 in business combinations and special entity status considerations for private entities, disclosure-related provisions of U.S. accounting treatments for taxes and other contingent liabilities, and suggested actions for companies affected by the new rules.

FIN 48—Now for Private and Public Entities: Lessons From Public Company Filings

By FRED F. MURRAY

Financial Accounting Standards Board Interpretation No. 48—Accounting for Uncertainty in Income Taxes, An Interpretation of FASB Statement No. 109,¹ though issued July 13, 2006, has been applicable

¹ FASB Interpretation No. 48—Accounting for Uncertainty in Income Taxes, An Interpretation of FASB Statement No. 109, Financial Accounting Standards Board, Norwalk, Conn., No. 281-B, June, 2006 (“FIN 48” or “the Interpretation”).

References to “FAS” are to particular statements, and to “FIN” are to particular interpretations, issued by the FASB. In June 2009, FASB issued FAS 168, The FASB Accounting Stan-

only to entities considered to be “public enterprises,” as further discussed in the next article in this series;

dards Codification[®] and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162, effective for financial statements issued for interim and annual periods ending after Sept. 15, 2009, except for nonpublic, nongovernmental entities that had not followed the guidance included in the American Institute of Certified Public Accountants Technical Inquiry Service (TIS) Section 5100, “Revenue Recognition,” paragraphs 38-76. As stated in FAS 168, on the effective date, the Accounting Standards Codification (“Codification” or “ASC”) will supersede all then-existing non-Securities and Exchange Commission accounting and reporting standards. All other nongrandfathered non-SEC accounting literature not included in the Codification will become nonauthoritative. Following this statement, the board will not issue new standards in the form of statements, FASB staff positions, or Emerging Issues Task Force abstracts. Instead, it will issue accounting standards updates. The board will not consider accounting standards updates as authoritative in their own right. Accounting standards updates will serve only to update the Codification, provide background information about the guidance, and provide the bases for conclusions on the change(s) in the Codification.

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through a staged process including several deferrals, its rules are soon to be applicable to many nonpublic entities as well.

This pronouncement has led to important consequences not only with respect to financial statements but also with regard to affected tax return filings and tax examinations as well.

Public companies now have three years of experience with the new rules. Many private enterprises, including partnerships, Subchapter S corporations, and other passthrough entities, and tax exempt organizations are just now beginning to understand the changes necessitated by these rules and their implications. This is important, as preparation a few months from now of annual financial statements that are subject to the rules involves a review and analysis of the accumulated tax positions that are part of them.

Private enterprises can benefit from the accumulated experience of public companies as they prepare for the issuance of these statements.

On the other hand, private companies, passthroughs, and tax exempt organizations have unique characteristics that may in some cases necessitate somewhat different approaches to issues raised and their solutions.

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FAS 109 can be found in the Codification at ASC 740. FIN 48 can be found in the Codification generally at ACS 740-10-25-5 through 25-8, 25-10 through 25-17, ASC 740-10-30-7, 20, ASC 740-10-35-3, 6, ASC 740-10-40-2, 3, 5, ASC 740-10-40-4, 5, ASC 740-10-45-4, 11, 12, 25, ASC 740-10-50-15, 19, ASC 740-10-55-3, 4, 5, 83, 85, 86, 88, and ASC 740-10-60-14.

The FASB Codification directly affects certain of the SEC's rules, regulations, releases, and staff bulletins, which refer to specific FASB standards or other private sector standard-setter literature under U.S. generally accepted accounting principles, because such references are now superseded by the FASB Codification. Although the FASB has stated that the FASB Codification supersedes existing references in U.S. GAAP, the SEC has stated in response that the FASB Codification does not supersede commission rules or regulations. Concurrent with the effective date of the FASB Codification, references in the SEC's rules and staff guidance to specific standards under U.S. GAAP should be understood to mean the corresponding reference in the FASB Codification. A longer term SEC staff updating initiative is planned to comprehensively revise specific references to specific standards under U.S. GAAP in the SEC's rules and staff guidance. SEC Release Nos. 33-9062; 34-60519, Aug. 17, 2009.

Private companies are generally, though not always, smaller than public companies, and may have smaller internal tax departments. Because they are not subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, they may not have developed comprehensive internal controls around the tax function. Unlike large public companies that are under continual examination by the Internal Revenue Service and other tax authorities, private entities may have little experience with tax examinations and, as a consequence little information that may prove helpful in evaluating tax positions.²

Tax exempt organizations are not generally as focused on tax matters,³ and private entities may in some cases have different attitudes about tax positions and their associated risks than large public companies who tend to focus on earnings metrics, securities trading and associated laws and exchange rules, and other public shareholder issues. Public companies have become more accustomed to the associated resource requirements in terms of internal personnel and external legal, accounting, and valuation consultants as a consequence.

Two important lessons learned from public companies are that it pays to start the overall FIN 48 compliance process sooner rather than later, and that they should carefully coordinate tax issues relating to international affiliates. Because the international affiliates of private enterprises may operate with a high degree of autonomy, gathering the necessary information and coordinating necessary analyses and actions may be challenging and especially resource-intensive. The international issues can have significant effects on related U.S. tax positions (e.g., transfer pricing, Subpart F income, and foreign tax credits).

Information Revealed So Far By Public Company Filings

FIN 48 provides for substantial new disclosures in the financial statements to which it is applicable. The FASB and SEC hoped that the new disclosures would decrease the abilities of some companies to manage earnings through the tax reserves and increase investor awareness of tax risks that were previously unknown.

On the other hand, commenters—including the author of this article—predicted that FIN 48 will ultimately result in more volatile company effective tax rates, and as a result more volatile earnings reports, and that reported tax liabilities, interest, and penalties will rise. Many have expressed concern about IRS use of the disclosures and possibly of the work paper files that support them—the so-called “roadmap”—leading to a rise in adjustments in audits, litigation, and possibly increased tax payments.

These predictions assume no behavioral changes, e.g., that companies will not become more conservative in their tax filing positions. But given some predictable

² The Internal Revenue Service Large and Mid-Size Business Division is, however, currently increasing its focus on larger partnerships and flowthrough entities.

³ This too is changing as the IRS Tax Exempt and Government Entities Division increases its activities in relation to unrelated business taxable income, activities and investments of tax exempt entities, and revisions to Form 990 to increase the information available to its officials (and the public).

conservatism, the new transparency might cause some companies to pay more taxes (whether or not they ultimately would have or should have owed them) either to avoid interactions between company managers and their board audit committees and auditors or to reduce the risk of asserted penalties and resultant disclosures in regulatory reports and in analysts' reports and the financial press. The disclosures could affect projections of cash flows and market rates of return, investor demands, and the cost of capital.

The public results of these implementation efforts are, however, just becoming evident, and we are learning from them.

Experience would suggest that many public company tax directors have historically taken a conservative approach under the methodologies allowed under FAS 5 that were applied to tax matters before the adoption of FIN 48 and established tax reserves approximating the amount of incremental taxes the tax director expected the company would have to pay given their judgments with respect to anticipated adjustments upon audit of the company's tax returns. (For example, an uncertain tax position might have been recognized in the financial statements as filed in the tax return, and if upon re-evaluation it became probable that the position would be compromised upon audit, the estimated amount of the loss would be added to the reserves.)

Temporary differences, particularly timing differences, may not have been recognized in the analysis. Detection risks were in some cases factored into the analysis and the resulting estimates recognized that some of the positions in the returns would be discovered by the related tax authorities, and would be compromised or lost in administrative proceedings or litigation. Conservatism in some cases led to the establishment of additional "cushion" amounts in the reserves to protect against uncertainties and surprises.⁴

The approach mandated by FIN 48 is very different. Among other changes, the new rules do not generally allow for aggregation of tax positions and general "cushion" amounts in the reserves are not permitted. Liabilities for unrecognized tax benefits must be recognized for tax positions that previously would not have given rise to an increase in the reserves. The Interpretation requires a position-by-position technical analysis of all tax positions of the enterprise.

If, upon adoption, the tax benefit from an uncertain tax position is recognized in the financial statements at an amount that is smaller than the tax benefit reported in the enterprise's tax return (and the deduction on the tax return reduced taxes payable for the period), a financial statement liability for unrecognized tax benefits is created under the Interpretation.⁵ A related deferred tax liability may also be recorded for the difference be-

tween the financial statement basis of the asset and the tax basis of the asset computed in accordance with FIN 48.

FIN 48 contains a number of new disclosure requirements, most of which will be discussed later in this series.

For example, FIN 48 requires the enterprise to disclose the cumulative effect of the change in retained earnings as a result of adoption in the statement of financial position as of the date of adoption, i.e., a cumulative-effect adjustment to the beginning balance of retained earnings for the difference between the amounts recognized in the statements of financial position prior to adoption of FIN 48, and the corresponding amounts recognized after adoption of FIN 48.

Under the Interpretation, enterprises that classify assets and liabilities in the presentation of their balance sheet or statement of financial position would classify such items as current or noncurrent based on the anticipated timing of settlement of the position (e.g., the position is subject to the expiration of a statute of limitations that will expire within 12 months). Such entities would classify a liability associated with an unrecognized tax benefit as a current liability, or reduce the amount of a net operating loss carryforward or amount refundable, to the extent that payment, or correspondingly receipt, of cash is anticipated within one year, or the operating cycle, if longer. Those assets and liabilities not expected to be settled within that period are classified in the noncurrent portion of the balance sheet.

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Interest recognized under these provisions may appear in the income statement above the line in pretax income or as part of tax expense, that is, it "may be classified in the financial statements as either income taxes or interest expense, based on the accounting policy election of the enterprise." Similarly, penalties required to be recognized under the provisions of the Interpretation "may be classified as either income taxes or another expense classification, based on the accounting policy election of the enterprise." While different policies may apply to interest and to penalties, these policies must be consistently applied, and changes in either policy are subject to the requirements of FAS 154,

⁴ A Tax Director Roundtable survey showed that 80 percent of companies that settled audits in the prior two years released tax reserves. This would indicate a tendency toward conservatism and an over-accrual for risks associated with uncertain tax positions. Levin, Petrin, Smith and White, *The View from Above—Reactions of Tax Committees to Tax Risks*, 84 *Taxes—The Tax Magazine* 111, 130 (2006).

⁵ Even if the tax position is not recognized for financial reporting, it still results in a current reduction in the company's tax bill, providing the company with a current cash flow benefit. That benefit should be seen in context with the possibility that the tax position will not be sustained, and further by the accrual of interest and possibly penalties as described below.

Accounting Changes and Error Corrections, paragraphs 17 and 18 (ASC 250).

Credit Suisse Securities Analysis

Credit Suisse Securities (USA) LLP published a comprehensive analysis of initial reporting under FIN 48 that also gives insights into information that may be available to a stock analyst or investor from the new public data made possible by these changes. Approximately 368 of the S&P 500 have calendar year end fiscal years and filed first quarter 2007 Form 10-Qs with the SEC that were analyzed in the report.⁶ The report stated in part:

... FIN 48 may highlight company-specific tax risks that investors were not previously aware of. If investors learn that a company actually bears more risk than was known before, that could have an impact on their estimates of future cash flows and the return that investors would demand (i.e., increased tax risk should increase the cost of capital), which could affect valuations. ... So how do we measure company specific tax risk? With the new information provided by FIN 48, we focus on the unrecognized tax benefit. Remember, this is the total amount of tax benefit taken on the tax return that has not yet been reported in the financial statements, calculated using a probability-based approach. Therefore, the larger this amount, the higher the tax risk, as the company may have to pay back taxes, penalties, and interest to the taxing authority if the tax position is successfully challenged. All else equal, the more exposure to uncertain tax positions, the more tax risk the company might bear. ... Of course, investors are forward-looking creatures by nature, so not only do you need to consider the risk associated with positions taken on previous tax returns, but on future returns as well. For example, if it is uncertain tax positions that have been driving a company's cash taxes lower in the past, not only might those be challenged, investors will have to reevaluate the sustainability of the company's cash tax rate into the future. ...

So now you are wondering, which companies might have more tax risk than others? To get a rough idea, we took a look at 361 of the 368 companies in the S&P 500 (as of May 14, 2007) with calendar year-ends (seven companies have yet to file their first quarter 10-Qs) as these are the first companies to apply FIN 48, having applied it in the first quarter of this year. ... We were able to pull out some key pieces of information, including the gross unrecognized tax benefits at the date FIN 48 was adopted (generally January 1, 2007), accrued interest and penalties, the impact of applying FIN 48, the amount of unrecognized tax benefit that would impact the effective tax rate, and potential changes in the unrecognized tax benefits over the next 12 months. In total, we found these companies had \$141 billion in unrecognized tax benefits. That sound you just heard was cash registers ringing at tax authorities around the world, \$141 billion is a nice chunk of change, which any tax authority would like to get a piece of. Some industry groups seem to have more exposure to uncertain tax positions than others, with the 11 industry groups listed ... accounting for over 60% of the total unrecognized tax benefits. ...

⁶ *Peeking Behind the Tax Curtain – FIN 48 Reveals Tax Risk*, Credit Suisse Securities (USA) LLC, May 18, 2007, (hereinafter the "Credit Suisse Analysis"). See also Blouin, Jennifer L., Gleason, Cristi A., Mills, Lillian F. and Sikes, Stephanie A., *What Can We Learn About Uncertain Tax Benefits from FIN 48?* (July 3, 2007). McCombs Research Paper Series No. ACC-02-07 Available at SSRN: <http://ssrn.com/abstract=990508>.

Tax Risk Report Card

... [T]he companies ... [with] the largest unrecognized tax benefits ... have the most tax risk, right? Not so fast. Just focusing on the absolute dollar amount of the unrecognized tax benefit is not enough. As one would expect, larger multinational companies tend to have larger uncertain tax positions. The key question is how significant the unrecognized tax benefits are to each company. For a better measure of tax risk, we decided to compare each company's unrecognized tax benefit at the date of adoption to four company specific metrics:

- Unrecognized tax benefit/cash taxes paid. This ratio roughly measures how many years of cash taxes have been reserved against. We compare the reserve to the trailing-five-year average cash taxes paid. The higher the ratio, the larger the potential increase in cash taxes if the uncertain position is not settled in the company's favor. The median ratio was 0.7 years, with a high of 260 years for Altera Corp.
- Unrecognized tax benefit/market cap. This ratio focuses on the size of the claim that the taxing authorities may have due to uncertain tax positions on the shareholders stake in the company (using market cap as of May 15, 2007). The higher the ratio, the larger the claim. The median ratio was 0.9%, ranging from a high of 14.9% for General Motors to a low of 0% for 14 companies.
- Unrecognized tax benefit/cash flow from operations. This ratio captures the taxing authorities' potential claim on the company's cash flows due to uncertain tax positions. We compare the reserve to the trailing-five-year average cash flow from operations. The higher the ratio, the larger the claim on cash. The median ratio was 12%, with a high of 1,344% for PMC-Sierra Inc.
- Unrecognized tax benefit/total liabilities. This ratio examines the significance of the unrecognized tax benefit relative to the total liabilities on the company's balance sheet (using liabilities as of the end of 2006). The median ratio was 1.5%, with a high of 29% for PMC-Sierra Inc. In our view, these are helpful metrics for evaluating a company's exposure to uncertain tax positions, or how much tax risk it may bear. ...

Quite simply, the Z-score focuses on the average. In the report card, average companies receive a Z-score of zero, while companies with above-average exposure receive a positive score, and those with below-average exposure receive a negative score. We then rank the companies by their combined Z-scores. The ten companies with the highest scores based on this methodology, or that appear to have the most exposure to uncertain tax positions (i.e., highest tax risk) are included in Exhibit 4 [See accompanying table "Exhibit 4."].

As we mentioned earlier the unrecognized tax benefit for Merck dropped significantly from the beginning of the year (the basis for our analysis) to the end of the first quarter. As you can see in Exhibit 4, Merck ranks as having the fourth highest tax risk among the 361 companies that we reviewed. If we were to use the unrecognized tax benefit from the end of March, Merck would drop six spots to number 10 in our tax risk ranking.

On the other end of the spectrum, the following 14 companies [See accompanying table "Exhibit 5."] appear to have the least exposure to uncertain tax positions (i.e., the lowest tax risk), disclosing either \$0 unrecognized tax-benefit or the unrecognized tax benefit was immaterial.

Far from the Perfect Measure of Tax Risk, But Not a Bad Starting Point

Of course, there may be problems with our approach to measuring tax risk. First of all, it does not fully capture a company's tax risk, as it does not evaluate the likelihood of a tax increase in jurisdictions where the company does business. There is also a significant amount of reliance upon management judgment. In addition the unrecognized tax benefits may not be comparable across companies—due

to accrued interest and penalties. Some companies include it as part of the unrecognized tax benefit, other companies exclude it, and for some it was unclear. Wherever possible we included accrued interest and penalties. The type of uncertain tax positions also vary across companies from those

that could eventually impact the effective tax rate, to timing differences and everything in between. In other words, it's far from a perfect measure; however, we think it's not a bad starting point for measuring tax risk. . . .

Exhibit 4: Highest Tax Risk

Company	Ticker	Unrecognized Tax Benefit/Cash Tax Paid	Unrecognized Tax Benefit/Market Cap	Unrecognized Tax Benefit/Cash Flow from Ops.	Unrecognized Tax Benefit/Total Liabilities	Z-Score
PMC-Sierra Inc. ¹	PMCS	27	8%	1,344%	29%	7.1
Altera Corp. ¹	ALTR	260	2%	40%	23%	5.5
General Motors ¹	GM	3	15%	236%	1%	2.6
Merck & Co.	MRK	4	6%	87%	27%	2.5
Allied Waste Industries ¹	AW	25	13%	76%	6%	2.4
Entergy Corp.	ETR	41	9%	83%	9%	2.3
Fluor Corp. (New) ¹	FLR	5	4%	331%	11%	1.9
Yahoo Inc.	YHOO	16	2%	63%	26%	1.8
PerkinElmer	PKI	3	5%	103%	18%	1.8
Black & Decker Corp.	BDK	4	7%	79%	11%	1.6

¹Not clear whether unrecognized tax benefit includes related accrued interest and penalties. Accrued interest and penalties were \$32.6 million for PMC Sierra Inc., \$22.7 million for Altera Corp, \$285.9 million for General Motors, \$187 million for Allied Waste, and \$64 million for Fluor Corp

Source: Company data, Credit Suisse estimates

Initial Impact of Changing the Accounting

To get an idea as to what type of impact FIN 48 has had on each company's tax reserves, we reviewed the first quarter 10-Qs and found that by applying FIN 48, the tax reserve increased for 171 companies, decreased for 94, and remained the same for 77. There were 19 companies where it was unclear how the tax reserve changed, if at all. For some companies, the tax reserve changed significantly. For example, Wyeth increased its tax reserve by \$295 million as a result of FIN 48; on the other hand, Ford Motor recognized a receivable of \$1.5 billion "associated with refund claims and related interest for prior years that meet the "more-likely-than-not" recognition threshold of FIN 48." All else equal, an increase in the tax reserve from applying FIN 48 can be viewed as an incremental claim on the shareholders (not a good thing for the stock price), while a drop in the tax reserve can be viewed as reducing a claim on the shareholders (good news for the stock price).

Conclusion

The next installment of this series will look at the new rules under FIN 48 and the development of practices around those rules. Future articles will look at the Interpretation's impact in business combinations and special entity status considerations for private entities, related disclosure requirements, and suggested actions

Exhibit 5: Lowest Tax Risk

Company	Ticker
Avalon Bay Communities	AVB
Developers Diversified Rlty	DDR
EOG Resources	EOG
General Dynamics	GD
Huntington Bancshares	HBAN
Jones Apparel Group	JNY
Kimco Realty	KIM
Plum Creek Timber Co.	PCL
Progressive Corp.	PGR
Public Storage	PSA
Questar Corp.	STR
Southwest Airlines	LUV
XL Capital	XL
XTO Energy Inc.	XTO

Source: Company data, Credit Suisse estimates.

for affected companies.

FIN 48—Now for Private and Public Entities: The New Rules and Developing Practices Around Them

This article, the second in the series, looks at the operation of the new rules when applied to private entities. Future articles will examine the impact of FIN 48 in business combinations and special entity status considerations for private entities, disclosure-related provisions of U.S. accounting treatments for taxes and other contingent liabilities, and suggested actions for companies affected by the new rules.

Financial Accounting Standards Board Interpretation No. 48—Accounting for Uncertainty in Income Taxes, An Interpretation of FASB Statement No. 109 (“FIN 48” or “the Interpretation”) is effective for entities considered to be “public enterprises,” as further discussed below, for fiscal years beginning after Dec. 15, 2006, and therefore effective Jan. 1, 2007, for calendar year public companies.¹

For certain “nonpublic enterprises” the effective date was deferred by FASB twice, and the application of guidance being prepared by the FASB staff was recently deferred as well. However, it is now quite likely that the requirements will finally and generally be applicable to all enterprises who prepare financial statements in accordance with U.S. generally accepted accounting principles in the next few months.

A nonpublic enterprise (as defined by Paragraph 289 of FAS 109,² as amended by FSP FAS 126-1) is an enterprise other than one:

- whose debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally);
- that is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets); or
- whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.³

The deferral does not apply to an enterprise that has issued publicly traded conduit debt (e.g., many universities and hospitals issue publicly traded debt).

¹ Earlier adoption is permitted as of the beginning of the fiscal year of an enterprise if no financial statements have then been issued for the fiscal year, including interim financial statements. FIN 48, Paragraph 22.

² “Nonpublic entity” in the Glossary of the Accounting Standards Codification.

³ Conduit debt securities refers to certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government’s financial reporting entity. Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. Further, the conduit bond obligor is responsible for any future financial reporting requirements.

FASB, on Dec. 19, 2007, issued proposed FASB Staff Position FIN 48-b that would defer the effective date by a year for “nonpublic enterprises” to fiscal years beginning after Dec. 15, 2007, for those entities that have not already adopted FIN 48. The language in the proposed FSP was clarified Jan. 8, 2008, when the board stated that the provisions of FIN 48 have been adopted if the nonpublic entity has issued financial information prepared in accordance with U.S. GAAP to third parties.

It is now quite likely that the requirements will finally and generally be applicable to all enterprises who prepare financial statements in accordance with U.S. GAAP in the next few months.

The board on Jan. 23, 2008, modified the proposed FSP and then adopted language to indicate that a nonpublic enterprise that is not a nonpublic consolidated entity of a public enterprise that applies U.S. GAAP would be eligible for the deferral unless it issued a full set of annual financial statements incorporating the recognition, measurement, and disclosure requirements of FIN 48.

In final FSP FIN 48-2, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises, the board concluded that FIN 48 would be required to be adopted by eligible nonpublic enterprises in annual periods beginning after Dec. 15, 2007.

Therefore, eligible nonpublic entities were first required to apply FIN 48 to annual financial statements issued for years beginning after Dec. 15, 2007. When it became effective, FIN 48 was to be applied as of the beginning of the enterprise’s fiscal year. Interim financial information provided to third parties prior to that time was not required to be in accordance with FIN 48 (i.e., calendar year-end companies would first adopt FIN 48 for financial statements for the full year ended Dec. 31, 2008).

Acknowledging that many nonpublic enterprises like partnerships and private companies may not have had time to prepare for the adoption of FIN 48, and that there are a number of significant issues that may arise in interpreting the application of its standards to them, the board concluded that the one-year deferral would

give nonpublic entities the necessary time to implement Interpretation 48.

Some specific situations that were identified that might qualify for the deferral provided (or not disqualify the enterprise from the deferred effective date) were:

- a nonpublic entity that issued interim-period financial statements or other GAAP-based financial information (e.g., debt covenant or net asset values calculations) in a period in which FIN 48 would have applied, but not a full set of annual financial statements;

- a nonpublic bank that issued call reports during 2007 that reflected the adoption of FIN 48 (the Federal Financial Institutions Examination Council (FFIEC) issued revised guidance that allowed nonpublic banks (that are not subsidiaries of a public entity) to be eligible for the deferral and reversed its earlier guidance that would have required nonpublic banks to adopt FIN 48 for call reports for 2007);

- a private U.S. company that is a subsidiary of a foreign parent that is public and issues international financial reporting standards-based financial statements (as the foreign parent does not issue financial statements prepared in accordance with U.S. GAAP—unless it is required to prepare a reconciliation to U.S. GAAP for a period in which the effects of FIN 48 would be required to be included, in which case the deferral would not be available);

- an unconsolidated private company that is reported as an equity method investment in a public registrant's financial statements; and

- a private nonpublic parent company that owns a public subsidiary.

However, after the issuance of FSP FIN 48-2, the FASB Private Company Financial Reporting Committee (PCFRC) and other constituents observed that significant questions remained about how to apply FIN 48 to passthrough entities and not-for-profit entities.

FASB subsequently adopted FSP 48-3, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Entities,⁴ on Dec. 30, 2008. The FSP deferred the effective date yet again for certain nonpublic enterprises to the annual financial statements for fiscal years that begin after Dec. 15, 2008. Nonpublic enterprises who had applied the Interpretation in a full set of annual financial statements issued before Dec. 30, 2008, or who are a nonpublic consolidated entity of a public enterprise that applies U.S. GAAP are ineligible for the deferral provided by FSP 48-3.

A nonpublic enterprise that elected the deferral had to:

- explicitly disclose its deferred application of the Interpretation; and

- for each set of financial statements where the deferral applies, disclose its method for evaluating uncertain tax positions.

The board concluded that the effective date deferral provided by FSP FIN 48-3 would give the board the time necessary to develop guidance on the application of FIN 48 to passthrough entities and tax exempt not-for-profit entities. From comments received, the board identified four common issues among the comments and questions—definition of an income tax, definition of a tax position, attribution of income taxes to the entity or

its owners, and financial statements of a group of related entities.

FASB issued proposed FSP FIN 48-d, Application Guidance for Pass-through Entities and Tax-Exempt Not-for-Profit Entities and Disclosure Modifications for Nonpublic Entities, on May 18, 2009. The comment period ended June 17. The guidance is further discussed below.

What the Rules Do—How They Are Applied

As more fully explained in an earlier article,⁵ FIN 48 applies to all tax positions accounted for in accordance with FAS 109. There are important limitations included in that statement.

First, the Interpretation, like FASB statements, notes that the provisions need not be applied to immaterial items.⁶ Staff Accounting Bulletin No. 99 (SAB 99)⁷ contains the views of the staff of the U.S. Securities and Exchange Commission concerning materiality in the preparation and audit of financial statements. Materiality is also a fundamental element of the disclosure system under both GAAP and the federal securities laws, and has application to many of the new disclosure rules. The meaning and interpretation of materiality is also the subject of case law, including Supreme Court decisions,⁸ and accounting literature, such as American Institute of Certified Public Accountants Statements on Auditing Standards No. 47 (SAS 47), Audit Risk and Materiality in Conducting the Audit, as amended by SAS 82.⁹

Further, when effective, FIN 48 applies to all entities or enterprises who report their results consistent with U.S. GAAP, including partnerships and other passthrough entities, tax exempt entities, and entities like real estate investment trusts and registered investment companies whose tax liability is subject to a 100 percent credit for dividends paid, and not just business enterprises who are registrants with the SEC.

FIN 48, like FAS 109, is a requirement of U.S. GAAP pronounced by the Financial Accounting Standards Board in the United States. While FAS 109 has an analogue in international financial reporting standards (IFRS) promulgated by the International Accounting Standards Board in IFRS 12, Income Taxes, there is no current analogue to FIN 48 contained in IFRS, although IAS 37 does include contingent income tax liabilities.¹⁰

⁵ Fred F. Murray, *FIN 48 Raises New Concerns in Reporting and IRS Review of Tax Positions*, BNA Daily Tax Report (4 DTR J-1, 1/8/07).

⁶ FIN 48, pg. 7.

⁷ SEC Codification of Staff Accounting Bulletins, Topic 1, Financial Statements, M. Materiality (as of April 2009).

⁸ See *TSC Industries Inc. v. Northway Inc.*, 426 U.S. 438 (1976) and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

⁹ AICPA, Codification of Statements on Auditing Standards (“AU”) Section 312.

¹⁰ Almost 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and other countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase, from a relative few in 2005 to approximately 110 in 2006, of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB. The commission expects to see this number continue to increase in the future, particularly pursuant to

⁴ ASC 740-10-65.

FAS 109 applies to domestic federal (national) income taxes (U.S. federal income taxes for U.S. enterprises) and foreign, state, and local (including franchise) taxes based on income, but does not govern accounting for taxes like sales and use taxes, value-added taxes, and others not so based. FAS 5, Accounting for Contingencies,¹¹ continues to cover contingencies for

Canada's announced move to IFRS, as there currently are approximately 500 foreign private issuers from Canada.

This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. The SEC published a Concept Release on Aug. 7, 2007, to obtain information about the extent and nature of the public's interest in allowing U.S. issuers, including investment companies subject to the Investment Company Act of 1940, to prepare financial statements in accordance with international financial reporting standards as published by the International Accounting Standards Board for purposes of complying with the rules and regulations of the commission. SEC Concept Release No. 33-8831, available at <http://www.sec.gov/rules/concept/2007/33-8831.pdf>.

The commission then proposed to accept from foreign private issuers their financial statements prepared in accordance with IFRS as published by IASB without reconciliation to U.S. GAAP as was required by current regulations. To implement this, the SEC proposed amendments to Form 20-F and conforming changes to Regulation S-X to accept financial statements prepared in accordance with the English language version of IFRS as published by the IASB without reconciliation to U.S. GAAP when contained in the filings of foreign private issuers with the commission. SEC Release Nos. 33-8818, 34-55998; International Series Release No. 1302, available at <http://www.sec.gov/rules/proposed/2007/33-8818.pdf>.

Subsequently, the commission published Release No. 33-8879 (March 4, 2008) in which it announced that it had considered the comments received and believed it appropriate to adopt the substance of the proposals previously announced for comment. In summary, the SEC provided that it would: permit foreign private issuers to file financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP; require that foreign private issuers taking advantage of this option state explicitly and unreservedly in the notes to their financial statements that such financial statements are in compliance with IFRS as issued by the IASB and provide an unqualified auditor's report that opines on that compliance; allow these foreign private issuers also to file financial statements for required interim periods without reconciliation to U.S. GAAP (and without providing disclosure under Article 10 of Regulation S-X) if the interim financial statements fully comply with IAS 34; extend indefinitely the two-year accommodation contained in General Instruction G of Form 20-F to all first-time adopters of IFRS as issued by the IASB; and, make conforming amendments to Rules 1-02, 3-10, and 4-01 of Regulation S-X, Securities Act Forms F-4 and S-4, and Securities Act Rule 701.

On Nov. 14, 2008, the SEC formally issued its proposed "Roadmap" that could lead to mandatory adoption by U.S. domestic financial report filers of IFRS beginning as early as 2014 for the largest financial report filers. The SEC said it is "proposing this Roadmap towards the mandatory, rather than elective, use of IFRS for U.S. issuers in order to promote fully a single set of high-quality globally accepted accounting standards to improve the comparability of financial information prepared by U.S. public companies and foreign companies." SEC Release No. 33-8982; Nov. 14, 2008, available at <http://www.sec.gov/rules/proposed/2008/33-8982.pdf>.

The effects of these changes, and whether and to what extent IASB will adopt requirements similar to FIN 48 in IFRS on its own or in relation to its convergence agreements with FASB is not clear at present, nor is the SEC course of action in these regards.

¹¹ Found at ASC 450 and 310, 360, 440, 460, 505, 720, 944.

those taxes that are not income taxes and related risks and uncertainties.

The concept, therefore, of what is an income tax is an important one in this context. For example, the application of these standards to alternative tax regimes at the state level or to certain foreign levies is often unclear. Recent examples include the new Texas Margin Tax, the new Ohio Commercial Activity Tax, and the Michigan Single Business Tax.

FIN 48 is the primary source of guidance for financial accounting for uncertainty in reporting tax positions, supplementing FAS 109, and removing income tax positions from the guidance provided in FAS 5. As more fully discussed below, FIN 48 treatment is much different than the treatment under FAS 5 applied to other contingent liabilities that are presented on the balance sheet of the enterprise.

FIN 48 provides a model in which only individual tax positions that meet certain criteria are recognized and measured and presented in the financial statements. Tax positions that do not initially meet the recognition criteria may subsequently be recognized if they meet the criteria in a later reporting period, and likewise, positions that fail to continue to meet the criteria may be derecognized in a later reporting period.

FIN 48 is the primary source of guidance for financial accounting for uncertainty in reporting tax positions, supplementing FAS 109, and removing income tax positions from the guidance provided in FAS 5.

The term "tax position" refers to a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets.

The term tax position also encompasses, but is not limited to:

- a decision not to file a tax return;
- an allocation or a shift of income between jurisdictions;
- the characterization of income or a decision to exclude reporting taxable income in a tax return; or
- a decision to classify a transaction, entity, or other position in a tax return as tax exempt.¹²

Each tax position is presented in the financial statements without being offset by other related positions, with one limited exception.¹³ The disaggregation rules

¹² FIN 48, Paragraph 4.

¹³ If the uncertain tax benefit creates or increases a net operating loss, the adjustment is netted with the net operating loss as if the NOL did not exist in the first place. If, on the other hand, the adjustment would be absorbed by an NOL, the presentation is made separately on a gross basis.

of FIN 48 that determine the presentation of tax positions are broader than the netting rules of FAS 109 (Paragraph 42 provides only that an enterprise shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions). These rules may produce distortions in perceptions of the information presented.

For example, the cost in taxes payable of an adjustment to a deduction resulting in the payment of more tax in a foreign jurisdiction may be fully or partially offset by an allowable U.S. foreign tax credit. The unrecognized tax benefit of the deduction in the foreign jurisdiction that is required to be presented under FIN 48 is not offset by the contingent deferred tax asset (as further adjusted by any necessary valuation allowances) represented by the increased foreign tax credit under FIN 48. The net exposure of the enterprise to tax risk may be zero, but the enterprise is not allowed to present the offsetting tax positions in that manner.

Two-Step Analysis

Once a tax position is identified and the applicable unit of account for the position is determined,¹⁴ the application of the Interpretation to a tax position requires a two-step process that first makes a determination as to whether a tax position has met the recognition threshold and then makes a determination or measurement of the amount that meets the recognition threshold.

Recognition of the Benefit

The first step of the process is to determine that the position has met the recognition threshold at the reporting date considering its technical merits, based upon the facts then existing and information then available: “The recognition threshold is met when the taxpayer (the reporting enterprise) concludes that . . . it is more-likely-than-not that the taxpayer will sustain the benefit taken or expected to be taken in the tax return in a dispute with taxing authorities if the taxpayer takes the dispute to the court of last resort.”¹⁵

¹⁴ The determination of the applicable unit of account is itself a critical decision. See Murray, *supra*, at J-5. In addition to its crucial effects on the initial recognition of the benefit (whether or not it can be recognized in the financial statements), the Interpretation also requires that the “unit of account should be consistently applied to similar positions from period to period unless a change in facts and circumstances indicates that a different unit of account is more appropriate.” FIN 48, Paragraph A9. Changing the unit of account from period to period may be difficult, requires additional analysis and documentation, discussions with auditors and audit committees, and perhaps disclosures, and decisions should be made not only with the current period but also future periods in mind.

¹⁵ FIN 48, Paragraph A2.

Use of the “more-likely-than-not” standard conforms to the Treasury Department tax practice regulations regarding “marketed opinions” (written advice the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending a plan or investment), in which the practitioner must reach a conclusion that the client will prevail on the merits at a confidence level of at least more likely than not with respect to each significant federal tax issue. T.D. 9165, 31 Code of Federal Regulations Part 10, Part 3, Section 10.35(c)(3)(iv).

The standard also conforms to the standards imposed by recent amendments to Section 6694 of the Internal Revenue

Paragraph 6 provides:

An enterprise shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. As used in this Interpretation, the term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. The more-likely-than-not recognition threshold is a positive assertion that an enterprise believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date.

In the case of taxable temporary differences, where the technical issues involved in the tax position are only those of timing of the deduction and not whether the amounts will be deductible, the process is truncated in each of the years in making a recognition decision—the analysis and presentation become a matter of measurement, discussed below, of the benefit. The Interpretation presents two examples illustrating the issues involved.¹⁶

The Interpretation supplies three assumptions that must be employed in making the determination. First, it “shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.”¹⁷ This assumption was subject to much debate in the development of the proposed interpretation and the Interpretation, and is important to the further development of the standards discussed below.¹⁸

Code of 1986 (the “Code”), as amended by Section 8246 of the Small Business and Work Opportunity Tax Act of 2007, Title VIII-B of Public Law No. 110-28 (121 Stat. 190), enacted into law on May 25, 2007, subsequently further amended by Section 506 of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Div. C of Public Law No. 110-343 (122 Stat. 3765) (the “2008 Act”) effective Oct. 3, 2008.

Section 6694 prescribes a penalty for certain conduct of “tax return preparers” as defined in Section 7701(a)(36). In addition to other important changes, the act amends the standards of conduct under Section 6694(a) in two ways. First, for undisclosed positions, the realistic possibility standard is replaced with a general requirement that there be a reasonable belief that the tax treatment of the position is supported by substantial authority as defined in the regulations. The 2008 Act creates a special rule if the position is with respect to a tax shelter (as defined in Section 6662(d)(2)(C)(ii)) or a reportable transaction to which Section 6662A applies (including both reportable transactions with a significant purpose of federal tax avoidance or evasion and listed transactions). Such a position is treated as unreasonable unless it is reasonable to believe that the position would more likely than not be sustained on the merits. Prior to the 2008 amendment, preparers were subjected to a generally applicable MLTN standard by the 2007 legislation.

Second, for disclosed positions, the not-frivolous standard is replaced with the requirement that there be a reasonable basis for the tax treatment of the position.

¹⁶ FIN 48, Paragraphs A26-A27, Paragraphs A28-A30.

¹⁷ FIN 48, Paragraph 7.

¹⁸ The board adopted an “asset approach” in the proposed interpretation and rejected the alternative “impairment approach,” an approach it believed relied in part on “detection risk,” the risk that a transaction will be reviewed or detected by taxing authorities. FIN 48 makes clear the board’s presumption that the position will be examined.

This assumption makes it clear that the “audit lottery” factor (i.e., risk of examination of the position) may not be used to assess the probability of sustention of the position. As we will see later in this discussion in regard to subsequent recognition of a tax position in a later period that was not previously recognized, FASB has adopted clarifications of the rules in a FASB staff position that may modify this requirement in particular circumstances.

The second supplied assumption is that the “[t]echnical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position. When the past administrative practices and precedents of the taxing authority in its dealings with the enterprise or similar enterprises are widely understood, those practices and precedents shall be taken into account.”¹⁹

The “audit lottery” factor (i.e., risk of examination of the position) may not be used to assess the probability of sustention of the position.

The administrative practices and precedents addition to allowable sources of authority would seem to be very helpful in those situations where the particular position may have been considered in current and past examination experience with a particular tax authority, its resolution did not derive from specific technical authorities of the types first mentioned, and the outcome gives rise to expectations for future behavior of the tax authority in similar circumstances.

While the limitations of “administrative practices and precedents” are understood to be narrow in scope but are nevertheless unclear, FASB staff earlier shed some light on the board’s consideration of comments from practitioners in the proposed interpretation. The proposed interpretation provided four examples that may support, in the absence of contrary evidence, a conclusion that a tax position meets the then required recognition threshold:

- unambiguous tax law supporting the tax position;
- an unqualified “should prevail”²⁰ tax opinion that is based on objectively verifiable conditions and issued by a qualified expert;

It should also be noted that under standards of tax practice applicable to tax opinions adopted by the American Bar Association, the American Institute of Certified Public Accountants, and the Treasury Department, practitioners may not use audit risk as a basis for their judgment as to whether a position will succeed on its merits. For example, Treasury regulations provide: “In evaluating the significant Federal tax issues addressed in the opinion, the practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.” T.D. 9165, 31 CFR Part 10, Paragraph 3, Section 10.35(c)(3)(iii).

¹⁹ FIN 48, Paragraph 7.

²⁰ The standard was changed to “more-likely-than-not” in the final Interpretation.

- similar positions clearly presented in prior years’ tax returns that have either been accepted or not challenged by tax authorities during examination; and,

- similar positions taken by other taxpayers, “where analogy is appropriate,” that were favorably resolved through litigation with tax authorities.²¹

The final Interpretation allows the use of administrative practices and precedents that are “broadly understood by preparers, tax practitioners, and auditors,” even where the practices and precedents may involve a technical violation of the law,²² and past settlements with tax authorities.²³ Both past practices of the enterprise’s tax examination teams and widely accepted administrative practices of a tax authority may provide, in appropriate limited circumstances, an exception to the technical merits approach to analysis of the position in question.

A given tax authority may approach particular issues in a manner that would give rise to such a practice (e.g., materiality or scope parameters in an audit agreement between the taxpayer and the authority (as perhaps with practices similar to Limited Issue Focused Examinations or the Compliance Assurance Program in the Internal Revenue Service Large and Mid-Size Business Division)²⁴ or an administrative practice with respect to capitalization of assets that are deemed to meet the required thresholds (as with the expensing of small dollar items²⁵)) where the position is deemed to meet the required technical merits whether or not it does in fact and whether the authority will or will not formally rule on the matter.

The failure to file a tax return in a nexus case is another example of such a precedent—in Paragraphs A14 and A15 of the Interpretation, the enterprise has become familiar with the administrative practices of the jurisdiction in question and understands that the jurisdiction will only look back six years in determining if there is a tax return due and deficiency owed. Because of the administrative practices of the taxing authority and the facts and circumstances, the enterprise is allowed to conclude that it more likely than not that a tax return is not required to be filed in the jurisdiction for earlier years and no liabilities for tax exposures for those periods are required upon implementation.

The third qualifying assumption is that each “tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions.”²⁶ This restriction would not allow consideration of a “horse trading” or mutual concession approach

²¹ Proposed interpretation, Paragraph 9.

²² FIN 48, Paragraphs B35-B37.

²³ Id., Paragraph A25.

²⁴ Paragraph B37 would seem to sanction such a result because it allows a limited technical violation of the law. However, Paragraph B36 cautions that whether a particular administrative practice or precedent will be applicable still involves a presumption that the tax position will be examined and that the taxing authority has the same information on the tax position that is available to the taxpayer when making its decision to apply the administrative practice or precedent. If the tax authority did not have sufficient information to reach an informed consent in reaching agreement to ignore the position, if the covered issues are significant in terms of required judgments or technical interpretations, the application has less foundation.

²⁵ See FIN 48, Paragraphs A12-A13.

²⁶ FIN 48, Paragraph 7.

(i.e., a compromise involving settlement of multiple issues in exchange for one another) to settlement of the issues involved in an administrative appeals process or while the matter is in litigation. Each tax position must be considered on its own—trading of issues does not provide information about the merits of a particular tax position, and that approach is continued in the recent developments discussed below.

Measurement of the Benefit

The second step of the process requires that the “enterprise recognize the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement” of the issues involved in the position.²⁷ The measurement process prescribed in the Interpretation involves a complex actuarial analysis of possible outcomes and their related probabilities to make the determination of the “largest amount that is greater than 50 percent likely of being realized.”

An example in Paragraph A25 of the Interpretation provides some limited relief in the situation where audit experience has led to an agreed treatment:

In applying the recognition criterion of this Interpretation, an enterprise has determined that a tax position resulting in a benefit of \$100 qualifies for recognition and should be measured. In a recent settlement with the taxing authority, the enterprise has agreed to the treatment for that position for current and future years. There are no recently issued relevant sources of tax law that would affect the enterprise’s assessment. The enterprise has not changed any assumptions or computations, and the current tax position is consistent with the position that was recently settled. In this case, the enterprise would have a very high confidence level about the amount that will be ultimately realized and little information about other possible outcomes. Management will not need to evaluate other possible outcomes because it can be confident of the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement without that evaluation.

This requirement of laying out possible outcomes and measuring their respective probabilities of occurrence is one of the most frequently discussed requirements of the new rules. It is not necessary to look at the entire range of possible outcomes incrementally at \$1 intervals, but in many cases the possible outcomes may be more than all or none.²⁸

It now seems clear that setting up and documenting cumulative probability tables like those reflected in Paragraphs A21 and A23 of the Interpretation may not be necessary in many or even most cases as even the In-

²⁷ FIN 48, Paragraph A4. Paragraph 8 provides: “A tax position that meets the more-likely-than-not recognition threshold shall initially and subsequently be measured as 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. Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon ultimate settlement using the facts, circumstances, and information available at the reporting date. As used in this Interpretation, the term reporting date refers to date of the enterprise’s most recent statement of financial position.” [Footnote omitted.]

²⁸ Examples of possible all or none positions are taxable versus nontaxable income, capital versus ordinary income, state income tax nexus or a foreign permanent establishment, state business versus nonbusiness income, and tax exempt status.

terpretation indicates that those examples are intended only to be illustrative in understanding the provisions of FIN 48.²⁹ FASB and SEC officials have made efforts to dampen concerns about documentation requirements in general and about this requirement.

For example, an SEC official stated:

We are not looking for a meaningless paperwork exercise. There was some concern when the standard was initially issued that somehow while the standard doesn’t say so anywhere within the text, that the requirement was to have a binder full of documentation and legal analysis for every single position, and we tried our very best to allow the FASB to calm the waters and to explain that companies should be spending their time and efforts on those positions that are right around the margin. The vast majority of positions that are relatively obvious need not go through a full analysis, probability table, and so on. Those should probably be dealt with in a much less draconian form of documentation.³⁰

It is nevertheless important to explain in the documentation of the position why a multitude of possible outcomes were not considered and why a single outcome (e.g., a settlement outcome) was chosen.

It is also nevertheless clear that consideration must be given to the possibility of multiple outcomes where they exist.³¹ And it is also clear that determining management’s “best estimate” in the form of a single value of the amount at which the position will ultimately be settled is not the correct approach.³²

²⁹ FIN 48, Paragraph A1.

³⁰ Remarks of Joseph Ucuzoglu, senior accounting fellow, Office of the Chief Accountant, Securities and Exchange Commission, webcast, *Perspectives on FIN 48 - What’s Next*, Tax Council Policy Institute, Washington, D.C., July 12, 2007.

³¹ Even in regard to highly certain tax positions, there may be only one outcome that may be reasonably anticipated but in others that may not be the case. For example, that a particular deduction may be allowable in some amount may be close to certain under the technical analysis required by recognition provisions of FIN 48, but the actual amount of the deduction that may ultimately be allowed may be less than certain in a given case (e.g., the taxpayer’s recordkeeping systems and documentation may be inadequate, or in the case of a royalty payment, the payment of a royalty may be fully supported by legal analysis but the valuation of an arm’s-length royalty rate may yield a range of values and be subject to at least some degree of controversy). Similarly, the treatment afforded by new Section 965 to dividends of repatriated amounts is subject to numerous underlying legal and factual determinations as to the nature of the distribution (including the determination of earnings and profits, which is itself a complex determination involving many underlying determinations), reinvestment planning and its implementation, and so on.

³² Most issues raised in an examination by IRS are settled either in administrative appeals or in litigation. The expectation is therefore seldom an all or nothing result, and in many cases, may be a range of values, with the taxpayer’s expectations of the final outcome falling somewhere within that range depending upon differing variables or assumptions, including the resolution of other issues. And the stricture in Paragraph 7 that a “tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions” applies to the recognition determination, but the fact that an administrative appeal may take into account the settlement of multiple issues on a mutual concession basis is permitted in evaluating the expectations of the range of outcomes that are measured. The Interpretation rejects the approach of determining a single best estimate in favor of the cumulative probabilities approach.

Interest and Penalties

When an underpayment of income taxes gives rise to an obligation to pay interest on the underpayment under applicable tax law,³³ the enterprise must begin recognizing interest expense in the first period in which the interest accrual would begin according to the relevant provisions of such laws, and such accruals would continue in each subsequent interim or annual period until the position is settled or otherwise resolved.³⁴

The amount of interest expense to be recognized is determined by computing the difference between the tax position recognized in accordance with the Interpretation and the amount previously taken or expected to be taken in a tax return and applying the applicable statutory rate of interest.³⁵

The amount of interest expense to be recognized is determined by computing the difference between the tax position recognized in accordance with the Interpretation and the amount previously taken or expected to be taken in a tax return and applying the applicable statutory rate of interest.

Similarly, if a tax position does not meet the minimum statutory threshold to avoid payment of penalties, an expense item for penalties (including “penalty inter-

³³ It may be possible to accrue interest on tax positions that involve an overpayment of tax as well where applicable law provides for interest to be paid by the taxing authority (e.g., a transfer pricing tax position that affects two jurisdictions—the failure of the tax position to meet the recognition criteria in the first jurisdiction may also give rise to a second tax position related to a correlative adjustment in the other, and where interest is paid on overpayments of tax, the two positions may give rise to interest expense in one jurisdiction and interest income in the other).

³⁴ Whether the definition of tax position is sufficiently broad to encompass interest and penalties that may apply to adjustments by tax authorities is unclear. They are separately provided for in the Interpretation, and commenters initially argued that they were not intended to be tax positions separate from the tax positions to which they may apply in a proposed adjustment. But as practice has evolved, some companies and firms have begun to treat the applicable penalties as tax positions subject to a separate FIN 48 analysis in making their determinations of associated tax positions, and have taken into account the “administrative practices and precedents” of a tax authority applicable to particular penalties in the process of resolution of a dispute over the primary positions. This is not to be understood as using a settlement position analysis like that under FAS 5 to estimate the ultimate amount due, but involves the evaluation of the penalty according to widely understood administrative practices and precedents of the authority relating to penalties that it applies in the facts at issue. It seems a reasonable approach as these amounts are imposed under separate technical provisions of the tax law than are applicable to the primary positions, and are often separately subject to appeal and litigation.

³⁵ *Id.*, Paragraph 15. Such interest is not eligible for capitalization under FAS 34, Capitalization of Interest Costs.

est,” or amounts above the “statutory interest rate”) must be recognized for the amount of applicable statutory penalties in the period in which the enterprise claims or expects to claim the position in the tax return,³⁶ with additional accruals in subsequent periods depending upon the nature of the penalty.

The effects on the financial statements of the required interest and penalties may be very significant, particularly over time, as they continue to accrue until the underlying position is resolved in a later period. For that reason alone, the effects of subsequent events described in the next section are very important.

Changes Brought by New Information And Subsequent Events

These initial determinations do not conclude the consideration of the effects of the tax position for financial statement purposes—that is, the position may be recognized in a subsequent period if not recognized before,³⁷ or may be derecognized, or the measurement of the item may be revised, if there is a subsequent change of judgment.

Specifically, the enterprise is required to recognize the financial statement effect of a tax position for which the more-likely-than-not threshold was not met in a previous period in which the tax position was taken or expected to be taken in the first subsequent interim period in which any one of the following conditions is met:

- the more-likely-than-not recognition threshold is met by the reporting date;
- the tax matter is “effectively settled”³⁸ through negotiation or litigation; or
- the statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.³⁹

These initial determinations do not conclude the consideration of the effects of the tax position for financial statement purposes—that is, the position may be recognized in a subsequent period if not recognized before, or may be derecognized, or the measurement of the item may be revised, if there is a subsequent change of judgment.

Similarly, the enterprise must “derecognize” a previously recognized tax position in the first period in

³⁶ *Id.*

³⁷ Initial recognition can occur in financial statements presented either before or after the position is reported in the tax return.

³⁸ Prior to the issuance of FSP FIN 48-1, the term was “ultimately settled.”

³⁹ FIN 48, Paragraph 10.

which it is no longer more likely than not that the tax position would be sustained upon examination.⁴⁰

Likewise, a previously recognized tax benefit may be remeasured if management's best judgment of the facts and circumstances then existing at the subsequent reporting date so dictate.

The subsequent judgment must be made upon new information and not from a new evaluation or new interpretation of information available in a previous financial reporting period.⁴¹

FSP FIN 48-1—Effectively Settled Positions

The “tax matter is settled through negotiation or litigation” basis for recognizing a tax position not previously recognized is discussed in Paragraph 12 of the Interpretation, where it states a “tax position need not be legally extinguished and its resolution need not be certain to subsequently recognize or measure the position.”⁴²

This reference and those in Paragraphs 8 and 10b to the concept of “ultimate settlement” raised questions about the required thresholds for recognition and remeasurement. Specifically, the settlement concept raises questions as to whether and when the circumstances under which an examination is closed or where an agreement to an administrative settlement is reached with IRS⁴³ or other tax authority may be suffi-

⁴⁰ Creation of, or adjustment to, a valuation allowance (as defined in FAS 109) is not a permitted substitute for derecognizing the benefit of a tax position previously recognized. FIN 48, Paragraph 11. Derecognition is implemented by recording a tax liability or directly reducing a deferred tax asset, with corresponding adjustments to related interest and penalties.

⁴¹ FIN 48, Paragraph 12.

⁴² “In considering the subsequent recognition of tax positions that do not initially meet the more-likely-than-not recognition threshold and the subsequent measurement of tax positions, the Board initially considered whether specific external events should be required to effect a change in judgment The Board concluded in the Exposure Draft that a change in estimate is a judgment that requires evaluation of all available facts and circumstances, not a specific triggering event During redeliberations, the Board considered whether a subsequent change in recognition or measurement should be reported only when a tax position is resolved with certainty. The Board does not believe that certainty is required and concluded that the recognition and measurement of a tax position at a reporting date should be based on management's best judgment given the facts and circumstances known at the reporting date. Unlike a Statement 5 approach to accounting for a loss contingency, information received subsequent to the reporting date should not be used to evaluate a tax position at the reporting date. Thus, finality or certainty of resolution of the tax matter is not necessary to subsequently recognize or measure tax positions. However, the Board also concluded that changes in judgment that lead to changes in recognition and measurement should result from the evaluation of new information. . . .” FIN 48, Paragraphs B46, B47.

⁴³ Section 7121 permits, but does not require, IRS to enter into closing agreements with taxpayers, and current service policy and procedure does not encourage them. Closing agreements are final and conclusive as to the issues covered (the entire liability for the tax period at issue or the treatment of specific issues) in most circumstances “except on a showing of fraud or malfeasance, or of misrepresentation of a material fact.” See also Q&A No. 4, *FIN 48 Implications—LMSB Field Examiners' Guide*, LMSB-04-0507-045, May 2007, available at <http://www.irs.gov/businesses/corporations/article/>

cient to justify a subsequent change in judgment about tax positions involved that may not have been previously recognized or that, if previously recognized might be remeasured (e.g., the benefit related to a particular deduction may be recognized and at 100 percent of the amount taken in the tax returns).^{44,45}

The FASB on Feb. 27, 2007, published for public comment proposed FSP FIN 48-a, Definition of “Settlement” in FASB Interpretation No. 48.⁴⁶ The proposed FSP contained language that would allow the subsequent recognition of a tax position when the position is

0,,id=171859,00.html, for discussion of IRS policy specific to FIN 48.

Many examination cases are closed with one of the forms in the Form 870 series, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, (not including Form 870-AD, Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment, in the administrative appeals process). These agreements provide a waiver of the taxpayer's rights to receipt of a mailed notice of deficiency and to a 90-day period for filing a petition in the Tax Court, and do not preclude the taxpayer from contesting the tax liability after payment of the tax or IRS from reopening the period being examined.

Form 866, Agreement as to “Final Determination of Tax Liability, is also rarely used, and is discouraged for many of the same reasons that closing agreements are not preferred. See also Q&A No. 6, *FIN 48 Implications—LMSB Field Examiners' Guide*, LMSB-04-0507-045, May 2007, available at <http://www.irs.gov/businesses/corporations/article/0,,id=171859,00.html>.

For those cases that are settled in IRS Appeals, a Form 870-AD is commonly used. Form 870-AD is a form used by the Appeals Office to settle cases informally, and contains a promise by the IRS commissioner that, if the offer is accepted, the case will not be reopened by the commissioner except in very limited circumstances, such as fraud or misrepresentation. (USDOJ Tax Division Settlement Manual, Section IV, n. 14; see also IRM 8.8.1.1.2, 3.) The Form 870-AD also provides that the case may be reopened if there is an important mistake in mathematical calculation, a deficiency or overassessment resulting from adjustments made under Subchapters C and D of Chapter 63 concerning the tax treatment of partnership and Subchapter S items determined at the partnership and corporate level, or an excessive tentative allowance of a carryback provided by law.

Under all these circumstances, judgment is required to determine whether the case has been closed, particularly with respect to a specific tax position (e.g., whether the issue was considered, whether it is within the scope of the agreement, the effect of the agreement, whether the agreement has been approved by the necessary officials, and so on).

⁴⁴ If the initial recognition threshold is not met on completion of the examination, and the examination may be reopened, the tax position is not recognized until either the technical merits are evaluated as more likely than not, a subsequent event in the administrative and litigation process occurs that would effectively bar the taxing authority from reopening consideration of the position (e.g., a closing agreement is entered and there is no fraud or misrepresentation involved), or the applicable statutes of limitations expire.

⁴⁵ As noted above, Paragraphs 8, 10(b), and 12 of FIN 48 contain the concept of how a tax position is “ultimately settled” and the effects of that concept on recognition of a tax position in the first instance, and subsequent recognition of a tax position based on new information that was not previously recognized because it did meet the more-likely-than-not threshold in the previous reporting period.

⁴⁶ ASC 740-10-25.

“effectively settled” in an examination by a tax authority.

An important point for consideration in making that determination is whether the tax authority has closed the relevant examination of the position (whether or not the position was specifically identified and examined in the course of the closed examination) or would continue its examination of the position, or would subsequently reopen the examination and re-examine the position:

c. Based on the taxing authority’s widely understood policy, the enterprise considers it highly unlikely that the taxing authority would subsequently examine or reexamine any aspect of the tax position included in the completed examination, presuming the taxing authority has full knowledge of all relevant information.

The staff finalized the FSP on May 2, 2007, changing the term “highly unlikely” to “remote,” presumably to give more clarity to the required judgments. The term remote as used elsewhere in accounting pronouncements, particularly FAS 5, indicates that the chance of the future event or events occurring is slight (generally less than 5 percent to 20 percent).

The final FSP amends FIN 48 (and contains specific language amending its provisions) to provide guidance on how an enterprise should determine whether a tax position is effectively settled for the purposes of recognizing previously unrecognized tax benefits, and changes the term “ultimate settlement” to “effective settlement”:

4. In accordance with paragraph 10(b) of Interpretation 48, an enterprise shall recognize the benefit of a tax position when it is effectively settled. An enterprise shall evaluate all of the following conditions when determining effective settlement:

a. The taxing authority has completed its examination procedures including all appeals and administrative reviews that the taxing authority is required and expected to perform for the tax position.

b. The enterprise does not intend to appeal or litigate any aspect of the tax position included in the completed examination.

c. It is remote that the taxing authority would examine or reexamine any aspect of the tax position. In making this assessment management shall consider the taxing authority’s policy on reopening closed examinations and the specific facts and circumstances of the tax position. Management shall presume the taxing authority has full knowledge of all relevant information in making the assessment on whether the taxing authority would reopen a previously closed examination.

5. In the tax years under examination, a tax position does not need to be specifically reviewed or examined by the taxing authority to be considered effectively settled through examination. Effective settlement of a position subject to an examination does not result in effective settlement of similar or identical tax positions in periods that have not been examined.

6. If an enterprise that had previously considered a tax position effectively settled becomes aware that the taxing authority may examine or reexamine the tax position or intends to appeal or litigate any aspect of the tax position, the tax position is no longer considered effectively settled and the enterprise shall reevaluate the tax position in accordance with Interpretation 48.

7. An enterprise may obtain information during the examination process that enables that enterprise to change its assessment of the technical merits of a tax position or of

similar tax positions taken in other periods. However, the effectively settled conditions in paragraph 4 of this FSP do not provide any basis for the enterprise to change its assessment of the technical merits of any tax position in other periods.

The guidance provided by the FSP would apply upon initial adoption of FIN 48 by the enterprise, and enterprises that have adopted approaches inconsistent with the FSP are required to retroactively apply the provisions of the FSP.

It should be noted that the FSP specifically notes an alternative view expressed by a FASB member that if a position is not examined in the course of an examination, no new information or evidence is obtained from the examination that should be considered in determining whether the recognition criteria have been met or continue to be met as discussed in Paragraphs 10(a), 11, and 12. The board member does not believe that using the “closing of a tax year” as a basis on which to treat a position as settled when a taxing authority has the ability to reopen and examine additional positions is appropriate, as it allows unexamined positions to be treated as “effectively settled.”

But a situation in which an adjustment is proposed by the taxing authority provides significant evidence that the taxing authority does not accept the position, and where the position is considered and the taxing authority does not propose an adjustment, that is significant evidence that the taxing authority accepts the position based on its technical merits. Further, where issues are traded off, the situation provides “very little evidence on which to analyze the first position.”

The FSP may allow in more circumstances for an earlier subsequent recognition of a tax position (it not being necessary to wait for expiration of the applicable statutes of limitations), and reversal of the related interest and penalty charges as well, when an audit is closed for a year in which the position is present in the cycle.

The FSP may allow in more circumstances for an earlier subsequent recognition of a tax position (it not being necessary to wait for expiration of the applicable statutes of limitations), and reversal of the related interest and penalty charges as well, when an audit is closed for a year in which the position is present in the cycle.

As the FSP cautions, the assessment should be made on a position-by-position basis, although the enterprise may conclude that all positions in a particular period are effectively settled. The conclusions are a matter of judgment as tax examinations proceed in a variety of ways. They must be based upon an evaluation of all the facts and circumstances, and must be based on “new information.”

It will be necessary in such situations to look at the specific facts and circumstances (including the legal status of the position in the examination, administrative

appeals, and litigation processes), what the parties know and when they became aware, what documentation of the facts may exist, what an agreement, if any, provides, and whether it is an effective disposition in reality of the issues in question.

If the examiners did not address the issue (e.g., it was never raised), depending upon materiality and other factors it may be necessary to consider whether the tax authority had sufficient information to make a determination to exclude the issue from the audit plan for the cycle. If the examination is completed for the year, it is necessary as in other situations to determine the probability that it will be reopened.⁴⁷

In such circumstances, the issue may nevertheless not be resolved⁴⁸—it may be necessary to wait for applicable statutes of limitations to expire.⁴⁹ And deter-

⁴⁷ For example, under the provisions of Revenue Procedure 2005-32, 2005-23 Internal Revenue Bulletin 1, June 6, 2005, an examination will not be reopened by IRS to make a further adverse determination unless there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact; the closed case involved a clearly defined, substantial error (defined therein); or other circumstances exist indicating that a failure to reopen the case would be a serious administrative omission. Further, under the stated policy of the revenue Procedure, where there is a “clearly defined, substantial error” an adjustment of such an unallowable item is not considered a reopening of the examination. See Section 4.03(1) (limited contacts that do not involve IRS inspecting the taxpayer’s books do not constitute a reopening of the examination) and Section 4.03(1)(d)(iii)(A) (an example of an IRS contact that is not an “examination, inspection or reopening” for an adjustment resulting from an unallowable item). See also IRM 1.2.1.4.1.5 — P-4-3 (the adjustment of an unallowable item, or an adjustment resulting from other types of service center return correction programs, is not considered an examination). These policies implement Section 7605(b) that prohibits an “unnecessary examination” of the taxpayer and restricts examinations to one inspection of a taxpayer’s books for any one taxable period, unless the treasury secretary, after inspection, notifies the taxpayer of the need to make an additional examination.

Rev. Proc. 2005-32 states that it applies to all examinations, inspections of books of account, and reopenings of cases closed after examination, regardless of taxpayer or type of tax, but does not extend to cases beyond the jurisdiction of the highest level field official with ultimate authority over the case, presently the area director for compliance or the industry director. It does not apply to cases closed after consideration by Appeals or any functional component of the Office of Chief Counsel. As noted above, the closure of a case under a closing agreement or a Form 870-AD provides additional assurances that a case will not be reopened. See also note 43. See also Q&A No. 9, *FIN 48 Implications—LMSB Field Examiners’ Guide*, LMSB-04-0507-045, May 2007, available at <http://www.irs.gov/businesses/corporations/article/0,,id=171859,00.html>.

⁴⁸ Absent the circumstances specified in Rev. Proc. 2005-32, supra, or applicable with respect to a Form 870-AD or closing agreement, the proposed FSP provides comfort that completion of the audit may close any further consideration of the involved position, but determining their absence is itself an application of professional judgment.

⁴⁹ If the initial recognition threshold is not met on completion of the examination, and the examination may be reopened, the tax position is not recognized until either new in-

forming the date of expiration of the statute may itself be difficult (e.g., extensions have been granted by the taxpayer,⁵⁰ or the issue is part of a transaction that is subsequently “listed” by IRS under the rules relating to tax shelters and “listed transactions” and required disclosures were not filed⁵¹).

And as to an issue not considered in the examination, the completion of the examination in itself does not provide further and new information that would change management’s evaluation of the technical merits of the position that would provide a basis for recognition of the position in other years (i.e., recurring issues).

The examination process may have other impacts. The completion of the examination may provide a basis for remeasurement of a previously recognized position in such circumstances (i.e., a change in the estimate of the amount that is more than 50 percent likely of being sustained on ultimate settlement).⁵²

Similarly, where new issues are raised or disposed of in the examination as it proceeds, the state of knowledge bearing on the position may change, and positions previously below the recognition threshold may be re-evaluated above the threshold, or the measurement of possible outcomes related to the position may change. An agreement may not be final (e.g., a Joint Committee on Taxation review may yet be required).

In each case, a judgment must be based on “new” information.

And, if a position is considered effectively settled, it may be appropriate to consider the effect of the settlement on other related tax positions (e.g., whether a settlement on the royalty rate used in a transfer pricing examination in one year could be considered to reassess similar tax positions on other royalties in the same year, or recurring issues on the same royalty in other open years).

Conclusion

The next installment of this series will examine FIN 48’s impact in business combinations and special entity status considerations for private entities. Future articles will address related disclosure requirements and suggested actions for affected companies.

formation allows the technical merits to be evaluated as more likely than not, a subsequent event in the administrative and litigation process occurs that would effectively bar the taxing authority from reopening consideration of the position (e.g., a closing agreement is entered and there is no fraud or misrepresentation involved), or the applicable statutes of limitations expire.

⁵⁰ See Q&A No. 3 (restricted consents), Q&A No. 5 (stipulations in closing agreements), *FIN 48 Implications—LMSB Field Examiners’ Guide*, LMSB-04-0507-045, May 2007, available at <http://www.irs.gov/businesses/corporations/article/0,,id=171859,00.html>.

⁵¹ See Q&A No. 8, *FIN 48 Implications—LMSB Field Examiners’ Guide*, LMSB-04-0507-045, May, 2007, available at <http://www.irs.gov/businesses/corporations/article/0,,id=171859,00.html>.

⁵² See the discussion of measurement of the position above, and Paragraph A25 of FIN 48.

FIN 48—Now for Private and Public Entities: Business Combinations and Entity Status Issues

This article in the series looks at the impact of FIN 48 in business combinations and special entity status considerations for private entities. Future articles will examine disclosure-related provisions of U.S. accounting treatments for taxes and other contingent liabilities, and suggested actions for companies affected by the new rules.

FIN 48 in Business Combinations: FAS 109 and FIN 48 Amended by FAS 141R

The Financial Accounting Standards Board on Dec. 4, 2007, issued Statement 141 (revised 2007), Business Combinations (FAS 141R),¹ which changes how a reporting enterprise accounts for the acquisition of a business in fiscal years beginning after Dec. 15, 2008.²

Under FAS 141R, business combination accounting applies to a wider range of transactions and events, including acquisitions of some development stage companies, combinations of mutual entities, acquisitions without the exchange of consideration, and the initial consolidation of a variable interest entity that is a business.

FAS 141R eliminated the previous cost-based purchase method under FAS 141, which recognized the acquired business as the sum of separately valued individual purchase layers (as in a step acquisition) and the carryover of the acquiree's basis for any remaining noncontrolling ownership interest in the acquiree. In general, FAS 141R requires acquisition-date fair value measurement of identifiable assets acquired, liabilities assumed, and noncontrolling interests in the acquiree.

Under FAS 141R, the value of the business acquired usually will be measured as the sum of the acquisition-date values (measured at fair value, with a few exceptions) of the following:

- consideration transferred for the acquiree;
- equity interests in the acquiree held by the acquirer immediately before the acquisition date (for an acquisition achieved in stages, also known as a step acquisition); and
- noncontrolling interests in the acquiree held by third parties (in a partially owned subsidiary)

The new measurement requirements result in the recognition of the full amount of acquisition-date goodwill including amounts attributable to noncontrolling interests. The acquirer recognizes in income any gain or loss due to remeasurement to acquisition-date fair value of consideration transferred or of previously acquired equity interests in the acquiree.

Neither the direct acquisition-related costs incurred to effect a business combination nor any costs the acquirer expects but is not obligated to incur under a plan to restructure an acquired business are included as part of the business combination accounting.

¹ Accounting Standards Codification 805.

² Statement 141R applies prospectively to business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after Dec. 15, 2008.

The acquisition method under FAS 141R does not apply to subsequent acquisitions of some or all of the noncontrolling interest in a subsidiary after the date of the business combination. FASB Statement 160, Noncontrolling Interests in Consolidated Financial Statements: an amendment of ARB No. 51,³ issued concurrently with Statement 141R, provides new guidance on the accounting for changes in the acquirer's ownership interests in a consolidated subsidiary and the presentation of noncontrolling equity interests in consolidated financial statements. FAS 160 is effective for fiscal years beginning on or after Dec. 15, 2008.

FAS 141R⁴ makes adjustments to the accounting for income taxes attributable to business combinations, and amends FAS 109 and FASB Interpretation No. 48 with respect to these changes. The amendments to FAS 109 and FIN 48 are applied prospectively to business combinations with acquisition dates before the effective date of FAS 141R.⁵

Therefore, FAS 141R will not change the accounting for previously recognized business combinations or previously recognized changes in valuation allowances on an acquired deferred tax asset (or changes in an acquired tax position). Prior to the effective date of FAS 141R, all subsequent period changes to a valuation allowance on an acquired entity's deferred tax asset would first reduce related goodwill to zero, then reduce to zero any other noncurrent intangible assets related to the acquisition, and finally reduce income tax expense.⁶

The FAS 141R amendments to FAS 109 and FIN 48 require that all changes in a valuation allowance for an acquired deferred tax asset or in an acquired uncertain tax position that occur after the effective date of FAS 141R will be recognized in accordance with the amended guidance. Therefore, except for certain measurement period adjustments, all such changes that occur after the effective date of FAS 141R are recognized as adjustments to income tax expense or contributed capital, as appropriate, even if the deferred tax asset or

³ ASC 810.

⁴ FAS 141R, Paragraphs 26-27, 66, 77, A97-A99, B279-B295, E22.

⁵ Acquisitions occurring during and after the first annual reporting period beginning after Dec. 15, 2008, will be subject to the new rules.

⁶ See the discussion of FASB Staff Implementation Guide, A Guide to Implementation of Statement 109 on Accounting for Income Taxes: Questions and Answers (Mar. 1992), Question 17, and EITF Issue No. 93-7, Uncertainties Related to Income Taxes in a Purchase Business Combination (May 1993). These rules are effectively repealed by the new provisions of FAS 141R for transactions that are subject to its provisions.

tax position was initially acquired prior to the effective date of FAS 141R.

Change in GAAP for Valuation Allowance

Under FAS 109, as amended by FAS 141R, a change in the acquirer's valuation allowance on its previously existing deferred tax asset as a result of a business combination will not be accounted for as part of the business combination and therefore, will not be accounted for as an adjustment to goodwill.

Business combination accounting under FAS 141R excludes the effects of an acquisition-date reduction of the valuation allowance on the acquirer's previously recognized deferred tax asset for net operating loss carryforwards, even if the allowance was reduced because the related tax benefits may be used against future taxable profits of the acquired entity. In contrast, under previous U.S. generally accepted accounting principles, such changes in a valuation allowance would be accounted for as part of the business combination.

Business combination accounting under FAS 141R

excludes the effects of an acquisition-date reduction of the valuation allowance on the acquirer's previously recognized deferred tax asset for net operating loss carryforwards, even if the allowance was reduced because the related tax benefits may be used against future taxable profits of the acquired entity.

FAS 141R also amended FAS 109 and FIN 48 on accounting for changes in the valuation allowance on an acquired entity's deferred tax asset, or an acquired tax position, to be consistent with the Statement 141R conditions for a measurement period adjustment and measurement of identifiable assets acquired.

Accordingly, a change in a valuation allowance for an acquired entity's deferred tax asset (or a change in an acquired tax position) will be recognized as follows: A change in the acquiree's valuation allowance (or in an acquired tax position) will be recognized through a corresponding change in goodwill if the change occurs during the measurement period and as a result of new information about facts and circumstances that existed as of the acquisition date.

If goodwill is reduced to zero, any additional decrease in the valuation allowance (or in an acquired tax position) would be recognized as a gain on a bargain purchase. The fair values of acquired noncurrent intangible assets would not be reduced prior to recognizing a gain. All other changes would be adjustments to income tax expense or contributed capital, as appropriate, and would not be recognized as adjustments to the acquisition-date accounting for the business combination.

The tax benefit for any excess of tax-deductible goodwill over the amount of goodwill for financial reporting will be a temporary difference at the acquisition date under FAS 109, as amended by FAS 141R. A deferred tax asset would be recognized as an adjustment to goodwill reported in the financial statements. In contrast, under previous GAAP, such tax benefits would be recognized as reductions of goodwill when realized on the tax return.

As illustrated in the FAS 141R amendments to FAS 109, the acquisition-date deferred tax asset on the excess of tax-deductible goodwill over book goodwill and the goodwill recognized for financial reporting are calculated as follows:

- **Preliminary Temporary Difference** = tax-deductible goodwill – book goodwill (before adjustment for the deferred tax asset associated with goodwill).

- **Deferred Tax Asset** = (tax rate ÷ (1 – tax rate)) x preliminary temporary difference.

- **Goodwill Recognized for Financial Reporting** = book goodwill (before adjustment for the associated deferred tax asset) – the associated deferred tax asset.

FAS 141R also provides for the income tax effects of the acquirer's replacement award of an acquiree's share-based payment award (replacement award) that is classified as equity and issued in a nontaxable business combination.⁷

Indemnification Assets

It is common practice for buyers and sellers of a business to agree upon indemnity for particular contingencies, including uncertain tax positions. The seller's complete or partial indemnification of the acquirer for the outcome of a particular uncertainty, such as an uncertain tax position accounted for under FIN 48, gives rise to an "indemnification asset."⁸

FAS 141R provides that the acquirer recognizes an indemnification asset at the same time that it recognizes the indemnified item (an indemnification asset would be recognized as of the acquisition date only if the indemnified item is recognized as of the acquisition date). For example, if a noncontractual loss contingency does not give rise to a liability that meets the more-likely-than-not recognition threshold on the acquisition date, the acquirer would not recognize an asset on the acquisition date for the seller's indemnification of that loss contingency.

An indemnification asset recognized under FAS 141R is measured on the same basis as the indemnified item according to the contractual terms of the agreement, using assumptions consistent with those used to measure the indemnified item. Therefore, the indemnification asset may not be measured at its acquisition-date fair value.

The amount recognized for an indemnification asset is also subject to management's assessment of collectability. A valuation allowance may be recognized at the acquisition date for an indemnification asset that is not measured at fair value, but no valuation allowance would be recognized for indemnification assets that are measured at fair value.

⁷ FAS 141R, Paragraphs A97-A99.

⁸ FAS 141R, Paragraphs 29-30, 64.

An acquired indemnification asset recognized as of the acquisition date under FAS 141R is subsequently re-measured each reporting date on the same basis as the indemnified asset or liability, subject to any contractual limitations on its amount. Amounts that are subsequently measured on a basis other than fair value are also subject to management's assessment of collectability. An indemnification asset is derecognized only when the acquirer collects it, sells it, or loses the right to it.

For example, assume a seller agrees to fully indemnify the acquirer for an uncertain tax position for which the acquirer recognizes an acquisition-date liability in accordance with FIN 48, as amended by FAS 141R. As of the acquisition date, the acquirer would recognize an indemnification asset for the same amount as the related liability, based on the acquirer's assessment that the asset is fully collectible. If the seller agrees to indemnify only a portion of the liability, the asset is measured on the same basis used to measure the indemnified liability but the indemnification asset is limited to the amount indemnified.

Issues in Applying FIN 48 to Private Entities (Including Partnerships, S Corporations, Other Passthroughs, and Tax-Exempts)

FASB issued proposed FASB Staff Position FIN 48-d, Application Guidance for Pass-through Entities and Tax-Exempt Not-for-Profit Entities and Disclosure Modifications for Nonpublic Entities, on May 18.

The overriding principle adopted by the exposure draft is that all entities are subject to FIN 48, even if the only tax position in question is the entity's status. Further, where it is more likely than not that the entity's status as a passthrough entity or tax-exempt entity would be sustained upon examination, the entity may have other tax positions to consider that fall within the scope of FIN 48. For example, an S corporation may determine that its status as a passthrough entity is more likely than not to be sustained upon examination, but in addition it also may be necessary to consider a tax position related to the built-in gains tax that would need to be addressed in accordance with the requirements of FIN 48.⁹

Passthrough entities and tax-exempt entities may be subject to the same tax positions found in other types of entities (e.g., nexus issues and the failure to file income tax returns or to pay income taxes; the underreporting of taxable income that may result from underreporting income and/or overstating deductible expenses). But such entities also face unique tax positions. One such tax position is the entity's tax status.

Management must determine whether the entity is in fact a passthrough entity or a tax-exempt entity in the jurisdictions in which it files a return or would otherwise be subject to income taxes. In addition, a tax-exempt entity must assess whether it has any tax positions associated with unrelated business income subject to income taxes.¹⁰

FSP FIN 48-d provides the following examples to illustrate the application of FIN 48 to private entities:

a. Entity A has sales in Jurisdiction S but no physical presence. Management has reviewed the nexus rules for filing a

return in Jurisdiction S and must determine whether filing a tax return in Jurisdiction S is required. In evaluating the tax position to file a tax return, management should consider all relevant sources of tax law. The evaluation of nexus has to be made for all jurisdictions where Entity A might be subject to income taxes. Each of these evaluations results in tax positions that are subject to the recognition, measurement, and disclosure requirements of Interpretation 48.

b. Entity S converted to an S Corporation from a C Corporation effective January 1, 20X0. In 20X7, Entity S disposed of assets subject to built-in gains and reported a tax liability on its 20X7 tax returns. Tax positions to consider related to the built-in gains tax include, but are not limited to, (1) whether other assets were sold subject to the built-in gains tax, (2) whether the income associated with the calculation of the taxable amount of the built-in gains is correct, and (3) whether the basis associated with the built-in gains calculation is correct. It should be noted that whether or not Entity S is subject to the built-in gains tax also is a tax position subject to the provisions of Interpretation 48.

c. Entity N, a tax-exempt not-for-profit entity enters into transactions that may be subject to income tax on unrelated business income. Tax positions to consider include but are not limited to (1) Entity N's characterization of its activities as related or unrelated to its exempt purpose, (2) Entity N's allocation of revenue between activities that relate to its exempt purpose and those that are allocated to unrelated business income, and (3) the allocation of Entity N's expenses between activities that relate to its exempt purpose and those that are allocated to unrelated business activities. Even if Entity N were not subject to income taxes on unrelated business income, a tax position it still has to consider is whether or not it qualifies as a tax-exempt not-for-profit entity.¹¹

A critical issue when evaluating the application of FIN 48 to a passthrough entity is whether the tax position is attributable to the entity or its owners. Under the exposure draft, management must determine whether the laws and regulations of the taxing jurisdiction attribute income taxes to the entity or its owners. That determination is itself a tax position subject to the requirements of FIN 48.

If the taxing jurisdiction's laws and regulations attribute income taxes to the entity, amounts due to or from the taxing jurisdiction are classified as income taxes and the recognition, measurement, and disclosure provisions of FIN 48 must be applied to those income taxes. If the taxing jurisdiction's laws and regulations attribute income taxes to the owners, amounts due to or from the taxing jurisdiction are classified as and accounted for as a transaction with owners.¹²

These questions arise because jurisdictions have different ways of assessing income taxes. Some impose the tax directly on the entity. Others impose the tax directly on the owners. Still others allow the entity to pay the tax on behalf of the owners of the entity.

In cases in which the entity remits the tax on behalf of the owners, some jurisdictions allow the owners to claim a refund if the taxes submitted by the entity are greater than the taxes that would have been owed by the owners had they filed and paid the income tax themselves. In other jurisdictions, the owners are not permitted to file a claim for refund. There are many ver-

⁹ FSP FIN 48-d, Paragraph 14.

¹⁰ Id., Paragraphs 15-20.

¹¹ Id., Paragraph 22.

¹² Id., Paragraph 23.

sions of this scenario because of the large number of taxing jurisdictions.¹³

The determination of whether income taxes are attributable to the entity or its owners is based on the laws and regulations of the taxing authority rather than on who pays the income taxes. Attribution is not based on obligations imposed by agreements between the entity and its owners.

The taxing jurisdiction often will collect income taxes from the entity because it is administratively easier, but the laws and regulations indicate that the payments are on behalf of the owners. Some jurisdictions allow the owners to utilize payments made by the entity if they choose to file an income tax return. In both of these situations, the evidence points to attribution to the owners even though the entity is making the payments.¹⁴

The determination of whether income taxes are attributable to the entity or its owners is based on the laws and regulations of the taxing authority rather than on who pays the income taxes. Attribution is not based on obligations imposed by agreements between the entity and its owners.

The following examples are provided to illustrate these principles:

a. Entity A, a partnership with two partners—Partner 1 and Partner 2—has nexus in Jurisdiction J. Jurisdiction J assesses an income tax on Entity A and allows Partners 1 and 2 to file a tax return and use their pro rata share of Entity A's income tax payment as a nonrefundable credit. Because the owners may file a tax return and utilize Entity A's payment as a credit against their personal income tax, the income tax would be attributed to the owners by Jurisdiction J's laws whether or not the owners file an income tax return. Because the income tax has been attributed to the owners, payments to Jurisdiction J for income taxes should be treated as a transaction with the owners. The result would not change even if there were an agreement between Entity A and its two partners requiring Entity A to reimburse Partners 1 and 2 for any taxes the partners may owe to Jurisdiction J. This is because attribution is based on the laws and regulations of the taxing authority rather than on obligations imposed by agreements between an entity and its owners.

b. If the fact pattern in paragraph 26(a) changed such that Jurisdiction J has no provision for the owners to file tax returns and the laws and regulations of Jurisdiction J do not indicate that the payments are made on behalf of Partners 1 and 2, income taxes are attributed to Entity A on the basis of Jurisdiction J's laws.

c. Entity S, an S Corporation, files a tax return in Jurisdiction J. An analysis of the laws and regulations of Jurisdiction J indicates that Jurisdiction J can hold Entity S and its owners jointly and severally liable for payment of income taxes. The laws and regulations also indicate that if payment is made by Entity S, the payments are made on behalf of the owners. Because the laws and regulations attribute the income tax to the owners, regardless of who pays the tax, any payments to Jurisdiction J for income taxes should be treated as a transaction with its owners.¹⁵

Related Entities

Where a group of related entities is involved, and regardless of the tax status of a consolidated or combined reporting entity, the consolidated or combined financial statements must include all tax positions for each entity within the consolidated or combined group that is subject to income taxes or that has taxable income assigned to it from a passthrough entity.

Determining which entities should be included in the reporting entity's financial statements is based on the application of GAAP. For example, the following example illustrates these principles:

Entity A, a partnership with two partners, owns a 100 percent interest in Entity B and is required to issue consolidated financial statements. Entity B is a taxable entity that has unrecognized tax positions and a related liability for unrecognized tax benefits. Because entities within a consolidated or combined group should consider the tax positions of all entities within the group regardless of the tax status of the reporting entity, Entity A shall include in its financial statements the assets, liabilities, income, and expenses of both Entity A and Entity B, including those relating to the application of Interpretation 48 to Entity B. This is true even though Entity A is a pass-through entity.¹⁶

The comment period on FSP FIN 48-d ended on June 17. On July 8, the FASB redeliberated the exposure draft, and decided that some issues would not be addressed in the guidance (e.g., the definition of an income tax). It also decided to eliminate some of the disclosure requirements that are applicable to public entities (to be discussed in the next article in this series). It should be borne in mind that its provisions may be further changed at the time it is issued.

Based on decisions reached by the board at its July 8 meeting, the staff will draft an accounting standards update to the Accounting Standards Codification that will be the subject of a vote of the board in a later meeting.

Conclusion

The next installment of this series will examine disclosure-related provisions of U.S. accounting treatments for taxes and other contingent liabilities, and the final article will look at suggested actions for companies affected by the new rules.

¹³ Id., Paragraph 24.

¹⁴ Id., Paragraph 25.

¹⁵ Id., Paragraph 26.

¹⁶ Id., Paragraphs 27-28.

FIN 48—Now for Private and Public Entities: Public Disclosures of Tax Positions

This article looks at disclosure-related provisions of U.S. accounting treatments for taxes and other contingent liabilities. The final article will examine suggested actions for companies affected by the new rules.

In crafting Financial Accounting Standards Board Interpretation No. 48—Accounting for Uncertainty in Income Taxes, An Interpretation of FASB Statement No. 109 (“FIN 48” or “the Interpretation”), the board struggled with the tension between providing useful information to users of financial statements that is consistent across the reporting base and sensitivities of enterprises concerned with protecting their tax information.

Nevertheless, perhaps the most controversial aspects of the new rules imposed by the Interpretation are the new and substantial additional disclosures that are required.

Financial Statement Presentation

FAS 109 requires recognition of the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the financial statements or tax returns of an enterprise as follows:

- A current tax liability or asset is recognized for the expected taxes payable (or refundable) on tax returns for the current year.¹ The amount of income taxes paid or payable (or refundable) as determined by applying the provisions of the enacted tax law to taxable income or excess of deductions over revenues for that year as reflected on various tax filings (exclusive of estimated tax payments and applied prior year overpayments) is generally the current provision for the period.²

- A deferred tax liability or asset is recognized for the estimated future tax consequences of existing temporary differences and tax carryforwards using the currently enacted tax rate that is expected to apply in the period of reversal.³

- The measurement of deferred tax assets is adjusted by means of a valuation allowance, if necessary, for tax benefits that, based on available evidence, are not expected to be realized in the future.⁴

- The change, if any, in the net deferred tax liabilities and assets for the period is generally the deferred tax expense or benefit for the year.⁵

These amounts are in many ways aggregated for presentation:

For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax liabilities and assets shall be offset and presented as a single amount and (b) all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an enterprise shall not offset deferred tax liabilities

and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions.⁶

In accord with these lines drawn around components and jurisdictions, FAS 109 requires that the enterprise disclose the total of all deferred tax liabilities, the total of all deferred tax assets, and the total valuation allowance recognized for deferred tax assets.

A public enterprise must also disclose the “approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances).”⁷ A public enterprise must disclose a tax rate reconciliation using percentages or dollar amounts of:

- the reported amount of income tax expense attributable to continuing operations for the year, to

- the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations.

One of the most widely discussed aspects of the rules has been the “granularity” or lack thereof of the presentations required by the old and the new rules—that is, the degree to which specific tax positions may be identified by investors or by revenue authorities from published information.

The estimated amount and the nature of “each significant reconciling item” must be disclosed in this rate reconciliation. Nonpublic enterprises may omit the tax effects of each type of difference, and the numerical reconciliation, when making their required disclosure of these amounts.⁸

In a classified statement of financial position, deferred tax liabilities and assets are separated into a current amount and a noncurrent amount based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting, including deferred tax assets related to carryforwards, is classified according to the expected reversal date of the

¹ FAS 109, Paragraph 8a.

² *Id.*, Glossary, pp. 112-113.

³ *Id.*, Paragraphs 17-19.

⁴ *Id.*, Paragraphs 17e, 20-21.

⁵ *Id.*, Paragraph 16.

⁶ FAS 109, Paragraph 42.

⁷ FAS 109, Paragraph 43.

⁸ FAS 109 requires other specific disclosures in particular circumstances. See Paragraphs 43-49.

temporary difference.⁹ The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

In theory and practice, the information presented under FAS 109 does not in many situations present specific information about particular tax positions. FIN 48 makes some significant changes in the approach to these issues. One of the most widely discussed aspects of the rules then has been the “granularity” or lack thereof of the presentations required by the old and the new rules—that is, the degree to which specific tax positions may be identified by investors or by revenue authorities from published information.

FIN 48 requires that a liability for an unrecognized tax benefit be reported on a gross basis.¹⁰

Favorable tax positions that may offset an unrecognized tax benefit are not netted with it, and must also be recognized and reported on a gross basis. This is the case even in circumstances where the liability does not affect a company’s effective tax rate because the positions would, if considered together, net to a zero liability.

For example, suppose the tax position under analysis is a possible transfer pricing risk in a particular jurisdiction. The fact that the position is almost certain to be subject of a correlative adjustment that would produce a net tax effect overall of zero is itself a separate tax position and must be accounted for separately. The same would be true if an adjustment for the unrecognized tax benefit would be offset by the benefit of a credit or deduction.

In such situations, the separate reporting of the positions may not only create additional complexity in the financial reporting of the position and require additional documentation, but also lead to a distortion of the reported apparent tax risks to which the enterprise may be subject (i.e., if only the unrecognized tax benefits are viewed without the association of the offsetting favorable tax positions, the reader may be led to the wrong conclusions).

If a tax benefit from an uncertain tax position is recognized in the financial statements at an amount that is smaller than the net tax-effected amount of the benefit as reported in the enterprise’s tax return (and the deduction on the tax return reduced taxes payable for the period), a financial statement liability for unrecognized tax benefits is created under the Interpretation.¹¹ A related deferred tax liability may also be recorded for the difference between the financial statement basis of the asset and the tax basis of the asset computed in accordance with FIN 48.¹² FIN 48 also provides for recogni-

tion of interest and penalties in the financial statements relating to such liabilities.

Under the Interpretation, enterprises that classify assets and liabilities in the presentation of their balance sheet or statement of financial position would classify such items as current or noncurrent based on the anticipated timing of settlement of the position (e.g., the position is subject to the expiration of a statute of limitations that will expire within 12 months). That is, such entities would classify a liability associated with an unrecognized tax benefit as a current liability, or reduce the amount of a net operating loss carryforward or amount refundable, to the extent that payment, or correspondingly receipt, of cash is anticipated within one year, or the operating cycle, if longer.

These amounts may not generally be combined with or offset by deferred tax liabilities or assets in the classified statement (except to the extent that it reduces a deferred tax asset).¹³ The general rule is that a liability for a FIN 48 position (liability for an unrecognized tax benefit) should be classified as a current or noncurrent liability, and is not classified as a deferred tax liability unless it arises from a taxable temporary difference.¹⁴

Interest recognized under FIN 48 may appear in the income statement above the line in pretax income or as part of tax expense, that is, it “may be classified in the financial statements as either income taxes or interest expense, based on the accounting policy election of the enterprise.”¹⁵ Similarly, penalties required to be recognized under the provisions of the Interpretation “may be classified as either income taxes or another expense classification, based on the accounting policy election of the enterprise.”¹⁶ While different policies may apply to interest and to penalties, these policies must be consistently applied, and changes in either policy are subject to the requirements of FAS 154, Accounting Changes and Error Corrections, Paragraphs 17 and 18.¹⁷

Although the information disclosed so far in enterprise financial statements, apart from that information in the footnotes and the Management’s Discussion and Analysis, has generally not disclosed much about individual tax positions involved, as discussed in the first article of the series it has nevertheless led to informative analysis of the tax risks of reporting organizations.

Changes Occurring and Reported In Interim Periods

As part of its interim reporting, the reporting entity is required to make its best estimate of the effective income tax rate expected for the full fiscal year, the estimated annual effective tax rate, reflecting the application of expected U.S. federal, state, and foreign graduated income tax rates to estimated annual earnings, adjusted for the effects of available tax credits, and applying the effects of income tax planning techniques. This estimate reflects the integral view of interim reporting, each interim period being a part of the annual period.

⁹ See FAS 37, Balance Sheet Classification of Deferred Income Taxes.

¹⁰ There is a limited exception: If the uncertain tax benefit creates or increases a net operating loss, the adjustment is netted with the net operating loss as if the NOL did not exist in the first place. If, on the other hand, the adjustment would be absorbed by an NOL, the presentation is made separately on a gross basis.

¹¹ See FIN 48, Paragraphs A26-A27.

¹² For purposes of FAS 109 and FIN 48, a particular asset or liability may have three different associated basis amounts: its basis for U.S. generally accepted accounting principles financial statements presentation, its basis as computed under FIN 48, and its basis as presented and filed in the associated tax return.

¹³ Id., Paragraph 17.

¹⁴ Id., Paragraph 18.

¹⁵ Id., Paragraph 19.

¹⁶ Id.

¹⁷ Accounting Standards Codification 250.10.50.

Changes in measurements or estimates are reflected depending on whether prior or the current annual reporting periods are involved,¹⁸ or prior or future interim periods in the same accounting period.¹⁹

For example, changes in income tax legislation are reflected in interim periods only after the enactment date of the legislation. Similarly, when a valuation allowance related to a deferred tax asset from a prior year is reduced or eliminated because of a subsequent change in judgment, the previously unrecognized income tax benefit is included as a discrete item in income tax expense or benefit in the interim period in which the judgment is revised. An increase in a valuation adjustment requires a catch-up adjustment to the current interim period income tax expense from continuing operations. In either event, the adjustment necessitated by a change in judgment is not prorated and allocated to future interim periods in the annual period by means of the effective tax rate estimate.

Changes resulting from one interim period in the same year that affect subsequent and future interim periods, however, are reflected by an adjustment of the estimated annual effective tax rate for the remainder of the year.

FIN 48 applies similar treatments to a change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position. Such an item taken in a prior annual period (including any related interest and penalties) must be recognized as a discrete item in the interim period in which the change occurs.²⁰ A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior interim period within the same fiscal year is an integral part of an annual period, and is reflected as provided in Accounting Principles Board 28, Paragraph 19,²¹ and FIN 18.²²

Footnote Disclosures and MD&A

In addition to a mandatory disclosure of its policy on classification of interest and penalties items in the footnotes to the financial statements,²³ an enterprise must make the following five disclosures at the end of each annual²⁴ reporting period presented (to the extent that

¹⁸ FAS 109, Paragraphs 35, 38.

¹⁹ Accounting Principles Board Opinion 28, Paragraph 19; FIN 18.

²⁰ FIN 48, Paragraph 13.

²¹ ASC 740.270.30.

²² FIN 48, Paragraph 14. ASC 740.270.

²³ Id., Paragraph 20.

²⁴ On Sept. 26, 2006, the Securities and Exchange Commission Regulations Committee of the American Institute of Certified Public Accountants met with staff of the SEC and jointly discussed questions related to disclosures related to adoption and implementation of FIN 48 by publicly traded companies, including certain post-adoption matters. Historically, the SEC staff has required that interim period financial statements filed on Form 10-Q that include the adoption of new accounting standards in that interim period present all the disclosures required by the new standard. In addition, the SEC staff has previously required that those disclosures continue to be provided in interim period financial statements filed on Form 10-Q subsequent to the quarter of adoption until the first annual financial statements are filed on Form 10-K after adoption that contain the required disclosures.

The AICPA raised questions related to the FIN 48 disclosures required of a public company in its Form 10-Q as of the

material changes in the items occur in interim periods during the year, disclosure should be considered²⁵).

Tabular Reconciliation

FIN 48 Paragraph 21a requires a tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end²⁶ of the period, which shall include at a minimum:

- the gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period,
- the gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period,
- the amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities, and
- reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.²⁷

Sample disclosure from the Interpretation for the year ended Dec. 31, 2007:

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows²⁸:

	(in millions)
Balance at January 1, 2007	\$370,000
Additions based on tax positions related to the current year	10,000
Additions for tax positions of prior years	30,000
Reductions for tax positions of prior years	(60,000)
Settlements	(40,000)
Balance at December 31, 2007	\$310,000

The amounts are presented on a gross, aggregated, and worldwide basis. Although separate lines are required for both additions and reductions in the first and second categories, the disclosures do not require the reporting of individual tax positions (unless of course that position is the single amount reported in the category),

date of adoption, including those that must be included in all interim financial statements in the year of adoption, addressing interim balances or activity during the current and year-to-date interim periods. The published responses indicate that SEC staff believes that the tabular reconciliation required by Paragraph 21a would not have to be included in interim reports, but that the other Paragraph 21 required disclosures should be implemented. In place of the tabular reconciliation otherwise required by Paragraph 21a, the entity should disclose the total amount of unrecognized tax benefits as of date of adoption. Material changes occurring post-adoption in interim balances or activity during the current and year-to-date interim periods should be disclosed in the statements, and if material amounts are recognized, consideration should be given to disclosure in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). See CPCAF Alert #138, Nov. 21, 2006, published by the AICPA Center for Public Company Audit Firms, at http://www.aicpa.org/cpcaf/download/FIN48_CPCAFAlert138.pdf.

²⁵ See Regulation S-X, 17 CFR 210.10-01(a)(5).

²⁶ The ending balance may or may not tie to the balance sheet depending upon accounting for deferred tax assets and liabilities.

²⁷ Id., Paragraph 21.

²⁸ Id., Paragraph A33.

or the amounts attributable to a particular taxing jurisdiction.

Reporting amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities has been interpreted to include only amounts that result from cash payments. A settlement of an unrecognized tax benefit in a return resulting from a concession of the issue in exchange for another issue, for example, would result in a direct reduction in the balance of prior period unrecognized tax benefits and would not be reported in the settlements category.

If accrued interest and penalties required by the application of FIN 48, or either of them, are reported as a component of income tax expense, and are therefore reported as part of income taxes payable in the balance sheet, these items are likely not included in the tabular reconciliation because accrued interest and penalties are not considered tax positions.

Because positions are reported on a gross basis, and not offset by other related positions, it is possible to draw incorrect inferences from the information presented. For example, the effects of an unrecognized tax benefit may be in reality fully offset by a favorable offsetting position in a deferred tax asset, resulting in a net exposure of the enterprise to further tax liability of zero.

Thus, it may be difficult or impossible to know from the information presented how much of the \$141 billion of unrecognized tax benefits reported in initial filings of 368 companies analyzed by Credit Suisse²⁹ and discussed in the first article of this series represent actual risk of loss. Nevertheless, the information can provide significant insights into the tax risks of a particular enterprise, particularly when viewed in conjunction with other information presented in the financial statements, including the information provided by the next requirement.

Unrecognized Tax Benefits In the Effective Tax Rate

FIN 48 Paragraph 21b requires disclosure of the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.³⁰

Sample disclosure from the Interpretation for the year ended Dec. 31, 2007:

Included in the balance at December 31, 2007, are \$60 million of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period.³¹

Unrecognized tax benefits that may not affect the effective tax rate essentially fall into two categories:

- those that may be offset by or netted against other tax positions in the computation of the effective tax rate³²; and

- those that may not affect the effective tax rate and the income tax provision, but would be recorded in equity or an asset such as goodwill or other intangible.³³

Examples of 2007 Form 10-Q filings that include illustrative examples of these principles include:

- **General Motors (2008 3rd Qtr.).** “At September 30, 2008 and December 31, 2007, the amount of consolidated gross unrecognized tax benefits before valuation allowances was \$3.1 billion and \$2.8 billion, respectively, and the amounts that would favorably affect the effective income tax rate in future periods after valuation allowances were \$265 million and \$68 million, respectively. The increase in the amounts that would favorably affect the effective tax rate is primarily related to adjustments resulting from our annual review of intercompany transfer pricing arrangements. At September 30, 2007, the amounts of gross unrecognized tax benefits before valuation allowances and the amount that would favorably affect the effective income tax rate in future periods after valuation allowances were \$2.5 billion and \$50 million, respectively. These amounts consider the guidance in FSP No. FIN 48-1, ‘Definition

offset by the generation and utilization of a foreign tax credit in the United States; tax positions that relate solely to timing (the liability for unrecognized tax benefits would be offset by an increase to a deferred tax asset or decrease in deferred tax liability); a tax position relating to a liability for state or local tax that is deductible in the United States, to the extent of the allowable deduction for U.S. federal purposes; and offsetting tax positions in two jurisdictions where the tax rates are the same.

³³ Stockholder’s equity (accumulated other comprehensive income) is directly charged or credited under FAS 109 with the initial income tax effects of items that are reported in stockholder’s equity without presentation on the income statement (some subsequent effects of these items such as those from changes in income tax laws and rates are accounted for in income from continuing operations); corrections for effects of accounting errors in previous periods; gains and losses that are part of comprehensive income but are not reported in the income statement, e.g., foreign currency translation adjustments under FAS 52, Foreign Currency Translation (ASC 830) and fair value adjustments to available-for-sale portfolios of debt and marketable equity securities held as investments under FAS 109 and FAS 130, Reporting Comprehensive Income (ASC 220); taxable or deductible increases in contributed capital, such as those attributable to offering costs; increases in the income tax bases of assets acquired in certain taxable business combinations; compensatory stock option plan expenses that are recognized for income tax purposes but reported in stockholder’s equity for accounting under APB 25, Accounting for Stock Issued to Employees; amounts paid on unallocated shares held in an employee stock ownership program and that are charged against retained earnings; and certain deductible temporary differences and net operating loss and credit carryforwards that existed at the date of a quasi-reorganization.

As a result of these and related rules, some unrecognized tax benefits that, if recognized, may not affect the effective tax rate include the following: tax positions acquired in, or arising from, business combinations, adjustments to which are reported in goodwill or another long-term intangible pursuant to Emerging Issues Task Force 93-7; reorganizations resulting in fresh start balance sheets recorded in equity pursuant to AICPA Statement of Position 90-7, Financial Reporting by Entities in Reorganization under the Bankruptcy Code; and excess tax deductions from stock-based compensation recorded in equity under FAS 123(R), Share Based Payment (ASC 505, 718), and APB 25. It may be necessary to include supplemental disclosures regarding these unrecognized tax benefits.

²⁹ *Peeking Behind the Tax Curtain – FIN 48 Reveals Tax Risk*, Credit Suisse Securities (USA) LLC, May 18, 2007.

³⁰ *Id.*, Paragraph 21.

³¹ *Id.*, Paragraph A33.

³² These tax positions may be involved in a number of situations, as for example: a position in a foreign jurisdiction in which the tax effect of the loss of a deduction would be fully

of Settlement in FASB Interpretation No. 48' (FSP No. FIN 48-1)."

■ **General Electric.** "At January 1, 2007, our 'unrecognized tax benefits'—that is, the aggregate tax effect of differences between tax return positions and the benefits recognized in our financial statements—amounted to \$ 6,806 million. If recognized, \$ 4,302 million of our unrecognized tax benefits would reduce our income tax expense and effective tax rate. Some portion of any such reduction might be reported as discontinued operations."

Interest and Penalties

FIN 48 Paragraph 21c requires disclosure of the total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position.³⁴

Sample disclosure from the Interpretation for the year ended Dec. 31, 2007:

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the years ended December 31, 2007, 2006, and 2005, the Company recognized approximately \$10, \$11, and \$12 million in interest and penalties. The Company had approximately \$60 and \$50 million for the payment of interest and penalties accrued at December 31, 2007, and 2006, respectively.³⁵

Examples of 2007 Form 10-Q filings that include illustrative examples of these principles include:

■ **General Electric.** "At January 1, 2007, before any tax benefits, our accrued interest on unrecognized tax benefits amounted to \$ 1,281 million and related accrued penalties amounted to \$ 121 million."

■ **Merck.** "In addition, at January 1, 2007, liabilities for accrued interest and penalties relating to the unrecognized tax benefits totaled \$ 2.40 billion."

■ **JP Morgan.** "Included in accounts payable, accrued expenses and other liabilities at January 1, 2007, was \$ 1.3 billion for the payment of income tax-related interest and penalties, of which the penalty component was not material."

■ **State Street.** "... on January 1, 2007, when our liability for unrecognized tax benefits was \$115 million. The application of the Interpretation's provisions did not change this liability. The liability includes \$95 million of interest, \$93 million of which relates to tax positions for certain of our leveraged leases for which there is uncertainty about the timing of tax deductions."

'Reasonably Possible' Changes

For positions for which it is reasonably possible³⁶ that the total amounts of unrecognized tax benefits will

³⁴ Id., Paragraph 21.

³⁵ Id., Paragraph A33.

³⁶ "Reasonably possible" is not defined in FIN 48 and the meaning is subject to differences of opinion. The term is defined in FAS 5 as "[t]he chance of the future event or events occurring is more than remote but less than likely. Remote is defined as "[t]he chance of the future event or events occurring is slight." Remote or slight has been interpreted to mean 5 percent to as much as 20 percent. Therefore "reasonably possible" would indicate a possibility of more than 5 percent and less than 50.1 percent (more likely than not) with an emphasis on the lower end of the range. Some commenters have interpreted that as approximately 40 percent. However, as some commenters have put it, if you are concerned about it, it is "probably" reasonably possible.

significantly increase or decrease within 12 months of the reporting date, FIN 48 Paragraph 21d requires disclosure of:

- the nature of the uncertainty,
- the nature of the event that could occur in the next 12 months that would cause the change, and
- an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.³⁷

Sample disclosure from the Interpretation for the year ended December 31, 2007:

As of December 31, 2007, the [Internal Revenue Service] has proposed certain significant adjustments to the Company's transfer pricing and research credits tax positions. Management is currently evaluating those proposed adjustments to determine if it agrees, but if accepted, the Company does not anticipate the adjustments would result in a material change to its financial position. However, the Company anticipates that it is reasonably possible that an additional payment in the range of \$80 to \$100 million will be made by the end of 2008.³⁸

An enterprise should note and consider the relationship in subsequent periods between the items disclosed in this 12-month lookforward and the items included in the tabular rollforward in the disclosures above, i.e., what effects there might be if the items are not foreshadowed in the previous periods.

A correlative issue is the granularity of the required responses, and the necessary level of detail with respect to individual tax positions that are responsive to the requirements of Paragraph 21d of FIN 48. An SEC official commented on these requirements:

There was a fair amount of divergence in some of the disclosures that I saw on granularity as to what exactly was in the 12 month look-forward. . . . The ultimate point here was to signal to the financial stakeholders what might change in the coming 12 months. The granularity as to where that was or where it was going to come from may have been secondary, although certainly some detail about that was intended to be disclosed. From a Corporate America standpoint, I can honestly say that we tried to get to a reasonable answer to accomplish both objectives: the transparency objective of FIN 48 in the disclosures to get the relevant information out . . . and not disclose too much to create a roadmap for audit authorities.

It may take initially twelve months to figure out how well people did, and if there are surprises, should they have been disclosed.

We appreciate the competing interests. Contrary to popular beliefs, FIN 48 was not written to provide a roadmap for the taxing authority. While it might have the ancillary impact of providing some additional information, that wasn't why the accounting standard setters went about writing it. It was written from the perspective of trying to provide the information that an investor would need to make an informed decision. So we certainly don't expect a company to go through each position and put together a whitepaper in the financial statements as to all of the facts, the technical authorities, and the tax code relied upon. I am not sure that is even meaningful to the average investor. What we are looking for though is somewhat transparent disclosures about the magnitude and type of exposures in either direction—either positive or negative—that might in fact have a material impact in the near term on either the company's cash flows, results of operations, or financial posi-

³⁷ FIN 48, Paragraph 21.

³⁸ Id., Paragraph A33.

tion, so that the investor has that information at his disposal.³⁹

As one might expect, it is likely that taxing authorities will be interested in these disclosures. This required disclosure has been the most controversial of the new disclosure requirements in relation to the concern that FIN 48 would provide a “roadmap” for IRS and other tax authorities to particular tax positions and allow an unfair advantage to those agencies in their negotiations with taxpayers in regard to those positions. An analysis published by the American Institute of Certified Public Accountants states:

If it is reasonably possible that the total amount of unrecognized tax benefits will increase or decrease significantly within 12 months of the reporting date, the financial statement must disclose the nature of the uncertainty, the nature of the event that could cause the change, and an estimate of the possible change, but may not have to disclose the particular jurisdiction.⁴⁰

Again, one overriding concern has been the necessary “granularity” or specificity of these disclosure requirements, and affected enterprises have struggled with them.⁴¹

A review of the initial rounds of disclosures in public filings would suggest that the disclosures made by companies are informative of the expectations of management of the range of expected changes without giving up much in terms of individual tax positions and their particulars. The level of granularity so far caused Credit Suisse to remark in its report discussed previously that “it’s not a roadmap; it’s more like a compass.”⁴² Some of the disclosures may not offer enough information from the standpoint of SEC comment letters discussed below.

IRS is quite interested in these disclosures. Particular disclosures or those of sufficient magnitude relative to examination criteria for the enterprise, especially if they are unexpected, may cause IRS to change its course in considering whether to close an examination.

IRS is quite interested in these disclosures. Particular disclosures or those of sufficient magnitude relative to examination criteria for the enterprise, especially if they are unexpected, may cause IRS to change its course in considering whether to close an examination,

³⁹ Remarks of Joseph Ucuzoglu, senior accounting fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, webcast, *Perspectives on FIN 48—What’s Next*, Tax Council Policy Institute, Washington, D.C., July 12, 2007.

⁴⁰ AICPA, *Practice Guide on Accounting for Uncertain Tax Positions under FIN 48*, p. 12, available at <http://theaicpa.org/NR/rdonlyres/8D2A444D-D158-4D5A-9F87-D8ED12A8A221/0/FIN48final.pdf>.

⁴¹ Thomas Jaworski, *Taxpayers Struggled With FIN 48 Rollforward*, *Disclosure*, 115 Tax Notes 906 (June 4, 2007).

⁴² Credit Suisse analysis, *supra*, pg. 14.

or in some circumstances may lead to a reopening of the examination for that year (subject to the procedural requirements of the Internal Revenue Code, Treasury regulations, and the policies described in the Internal Revenue Manual).

Examples of 2007 Form 10-Q filings that include illustrative examples of these principles include:

■ **General Electric.** “During 2007, global audit resolutions could potentially reduce our unrecognized tax benefits, either because our tax positions are sustained on audit or because we agree to their disallowance, by as much as \$ 1,900 million, depending on the outcomes of ongoing examinations and litigation. Of this amount, \$ 1,000 million relates to positions that would not affect our total tax provision or effective tax rate.”⁴³

■ **Boeing.** “If tax matters for 1998-2003 ultimately settle with the Internal Revenue Service within the next 12 months, the total amounts of unrecognized tax benefits may increase or decrease for all open tax years. Settlement could (decrease)/increase earnings in an amount ranging from (\$ 5) to \$ 340 based on current estimates. Audit outcomes and the timing of audit settlements are subject to significant uncertainty.”

■ **Altria.** “[I]t is reasonably possible that within the next 12 months certain U.S. state and foreign examinations will be resolved,” providing \$ 105 million in profits for the company. Those profits would come if the taxing authorities allowed tax benefits that the company claimed but did not report to investors, presumably because it thought there was a risk they would not be approved.

■ **Qwest Communications.** “If the settlement is effected in accordance with our expectations, we believe that it is reasonably possible that we could recognize up to \$ 134 million of tax and interest benefits (including up to a \$ 95 million increase in net income), and our total unrecognized tax benefits may decrease by approximately \$ 221 million by December 31, 2007.”

■ **Bristol Myers Squibb.** “The Company anticipates that it is reasonably possible that the total amount of unrecognized tax benefits will decrease within 12 months of the date of adoption of FIN No. 48, in the range of approximately \$ 320 million to \$ 360 million as a result of the settlement of certain tax audits.”

■ **Occidental Petroleum.** “It is reasonably possible that Occidental’s existing liabilities for uncertain tax benefits may increase or decrease within the next twelve months primarily due to the progression of audits in process or the expiration of statutes of limitation. Occidental cannot reasonably estimate a range of potential changes in such benefits due to the unresolved nature of the various audits.”

Tax Years Subject to Examination

FIN 48 Paragraph 21e requires a description of tax years that remain subject to examination by major tax jurisdictions.⁴⁴

Sample disclosure from the Interpretation for the year ended Dec. 31, 2007:

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years

⁴³ Note the included FIN 48 Paragraph 21b disclosure.

⁴⁴ *Id.*, Paragraph 21.

before 2001. The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 2002 through 2004 in the first quarter of 2007 that is anticipated to be completed by the end of 2008.⁴⁵

The meaning of "major tax jurisdiction" is unclear at present, but the same materiality concerns that drive other disclosures in this area of the footnotes would require a careful review of open years and issues.

Disclosures at Adoption And in MD&A Contractual Obligations Table For Public Companies

In addition to those disclosures described above, FIN 48 requires the enterprise to disclose the cumulative effect of the change in retained earnings as a result of adoption in the statement of financial position as of the date of adoption, i.e., a cumulative-effect adjustment to the beginning balance of retained earnings for the difference between the amounts recognized in the statements of financial position prior to adoption of FIN 48, and the corresponding amounts recognized after adoption of FIN 48.⁴⁶

This disclosure is required only in the year of adoption.⁴⁷ If a change is made upon adoption of the classification of interest and penalties in the financial statements, additional disclosures as provided by Para-

⁴⁵ Id., Paragraph A33.

⁴⁶ While most of the required adjustments upon adoption will be reflected in adjustments to retained earnings, it is possible that correlative adjustments may be reflected elsewhere for amounts that would not have been recognized in earnings, e.g., in adjustments related to a previous business combination accounted for on the purchase method that may be required to be reflected in adjustments to recorded goodwill or other accounts. See FASB EITF 93-7, Uncertainties Related to Income Taxes in a Purchase Business Combination, and Q&A No. 17, FASB Staff Q&A on Statement No. 109, A Guide to Implementation of Statement 109 on Accounting for Income Taxes: Questions and Answers (revised 6/6/06), FAS 109, and FAS 141, Business Combinations. FIN 48 partially amends those authorities and controls the recognition and measurement of tax positions acquired in a purchase business combination, but those authorities continue to be applicable to the classification of subsequent adjustments resulting from resolution of tax uncertainties and to purchase accounting. Adjustments made upon resolution of tax positions that were acquired in and predate a purchase business combination or that result from it, including tax reserves and basis adjustments established in the combination, generally should be recorded as an increase or decrease to goodwill, other noncurrent intangible assets related to the acquisition, and income tax expense (in the manner and order provided therein) without regard to the elapsed time since the acquisition date. Post-acquisition interest is accounted for under Paragraph 15 of FIN 48 and is accrued and adjusted through the income statement.

On Dec. 4, 2007, FASB issued Statement 141 (revised 2007), Business Combinations (FAS 141R) (ASC 805), which changes how a reporting enterprise accounts for the acquisition of a business in fiscal years beginning after Dec. 15, 2008. Statement 141R applies prospectively to business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after Dec. 15, 2008.

⁴⁷ FIN 48, Paragraph 24.

graphs 17 and 18 of FAS 154⁴⁸ should also be considered.⁴⁹

Sample disclosure from the Interpretation for the year ended Dec. 31, 2007:

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. As a result of the implementation of Interpretation 48, the Company recognized approximately a \$200 million increase in the liability for unrecognized tax benefits, which was accounted for as a reduction to the January 1, 2007, balance of retained earnings.⁵⁰

An example of 2007 Form 10-Q filings that include illustrative examples of these principles includes:

Waste Management, Inc. (2nd Qtr.). As disclosed in our Form 10-Q for the quarterly period ended March 31, 2007, we adopted FIN 48 effective January 1, 2007. As a result of the implementation of FIN 48, on January 1, 2007, we recognized, as a cumulative effect of change in accounting principle, a \$121 million increase in our liability for unrecognized tax benefits, a \$36 million increase in our non-current deferred tax assets and an \$85 million reduction to our beginning retained earnings.

On May 2, 2007, after our first quarter 2007 Form 10-Q was filed, the FASB issued FASB Staff Position ("FSP") No. FIN 48-1, *Definition of Settlement in FASB Interpretation No. 48* ("FSP No. 48-1"), to provide guidance associated with the criteria that must be evaluated in determining if a tax position has been effectively settled and should be recognized as a tax benefit. Companies that did not initially apply FIN 48 in a manner consistent with provisions of FSP No. 48-1 are required to retrospectively apply the provisions of the FSP as of the date of initial adoption of FIN 48.

The additional guidance provided by FSP No. 48-1 significantly changed the impact of our implementation of FIN 48. This is generally because our initial implementation resulted in the re-establishment of liabilities for tax positions

⁴⁸ FASB Statement No. 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20 and FASB Statement No. 3.

⁴⁹ In the Sept. 26, 2006, meeting between the SEC Regulations Committee of the AICPA and staff of the SEC, the AICPA also inquired about applicability of Item 601(b)(18) of Regulation S-K, which requires a "preferability letter" to be included in filings of Form 10-Q and 10-K for changes in accounting principles. If a registrant makes a change in a method of accounting to an alternative method of accounting, the registrant may have to justify the change as being to a preferable one in the circumstances and an independent accountant may have to prepare and submit a letter stating that in his or her view the change is to a principle that is preferable in the circumstances under Rule 10-01(b)(6) of Regulation S-X. Item 601(b)(18) of Regulation S-K provides that the independent accountant's preferability letter be filed as an exhibit to reports on Forms 10-K or 10-Q.

FIN 48 states that classification of interest and penalties on income tax positions is an accounting policy that requires disclosure. The AICPA position was that while such a change might represent an accounting change for which FAS 154 would require a registrant to establish preferability, it would be appropriate to have a "one-time safe harbor" upon adoption of FIN 48 to change its classification policy without establishing preferability. The SEC staff reportedly, upon consideration, indicated that a preferability letter would not be required upon adoption, given that acceptable alternatives to the income statement classification of such interest and penalties existed prior to FIN 48 and continue to exist after its adoption. However, after adoption, the SEC staff indicated that a preferability letter is required for a material change in a registrant's accounting policy regarding such classification.

⁵⁰ FIN 48, Paragraph A33.

that did not meet the ultimate settlement guidelines initially established by FIN 48 because the applicable statutes of limitations had not expired. We believe these tax positions were effectively settled as of January 1, 2007 as described by the provisions of FSP No. 48-1 largely because these positions were covered by settlements with the relevant taxing authorities. Accordingly, we have made a retrospective adjustment to our January 1, 2007 balance sheet to incorporate the effects of FSP No. 48-1. Our revised cumulative effect of change in accounting principle is a \$28 million increase in our liabilities for unrecognized tax benefits, a \$32 million increase in our non-current deferred tax assets and a \$4 million increase in our beginning retained earnings.

In addition, during the first quarter of 2007, we reached a tax audit settlement, which, in accordance with the provisions of FIN 48 prior to the issuance of FSP No. 48-1, was not recognized in our Condensed Consolidated Statement of Operations as the applicable statutes of limitations had not expired. Applying FSP No. 48-1 retrospectively to January 1, 2007 resulted in the previously unrecognized tax benefit associated with this tax audit settlement being reflected as a reduction to our "Provision for income taxes," increasing our previously reported "Net income" for the three months ended March 31, 2007 by \$16 million, or \$0.03 per diluted share.

Refer to Note 5 for additional information about our unrecognized tax benefits.

In addition to the other disclosures described above, questions have been raised about the inclusion of contingencies related to FIN 48 liabilities in the Contractual Obligations Table of the MD&A. The SEC adopted Jan. 22, 2003, final rules under Section 401(a) of the Sarbanes-Oxley Act of 2002 and new Section 13(j) of the Securities Exchange Act of 1934 relating to the disclosure of off-balance sheet arrangements and known contractual obligations.

The new rules amend requirements for management discussion and analysis disclosures in registration statements, periodic reports, and proxy or information statements that are required to include financial statements.

The new rules amend requirements for management discussion and analysis disclosures in registration statements, periodic reports, and proxy or information statements that are required to include financial statements.⁵¹ The MD&A rules already required disclosure regarding off-balance sheet arrangements and other contingencies. They are designed to cover a wide range of corporate events, including events, variables, and uncertainties not otherwise required to be disclosed under U.S. generally accepted accounting principles.

For example, the MD&A rules require disclosure of:

⁵¹ See SEC Release Nos. 33-8182; 34-47264; FR-67; International Series Release No. 1266, effective April 7, 2003. The full text of the final rules can be found at <http://www.sec.gov/rules/final/33-8182.htm>.

- information necessary to an understanding of the registrant's financial condition, changes in financial condition, and results of operations; and

- any known trends, demands, commitments, events, or uncertainties that will result in, or that are reasonably likely to result in, the registrant's liquidity increasing or decreasing in any material way.⁵²

The new regulations require a registrant to provide specified disclosures of certain off-balance sheet arrangements and obligations and a tabular disclosure of contractual obligations of certain obligations.⁵³ It is now clear that a liability related to unrecognized tax benefits must be included in the Contractual Obligations Table, and a good faith effort should be made to schedule them out between those to be settled in the current period and later periods as required under the regulations.⁵⁴ There may need to be footnote disclosures for others not scheduled in the table. By definition, the FIN 48 uncertain tax benefit is viewed as an obligation.⁵⁵

Reduced Disclosure Requirements For Nonpublic Enterprises

In making its comments on FASB FSP FIN 48-d, the Private Company Financial Reporting Committee commented that certain disclosures required by FIN 48 were not useful to users of private company financial statements.

Some FASB Board members and staff met with users of private company financial statements from the PC-FRC and others to discuss the disclosure requirements of Interpretation 48. After confirming that view with users, the board decided to modify the disclosure requirements for nonpublic entities to eliminate the disclosures required by Paragraphs 21a (tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period) and 21b (total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate) of FIN 48.⁵⁶

It should be borne in mind that its provisions may be further changed at the time it is issued. Based on decisions reached by the board at its July 8 meeting, the staff will draft an accounting standards update to the Accounting Standards Codification, which will be the subject of a vote of the board at a later time.

SEC Response

Given the regulatory developments that led to them, departures from these rules may draw comment letters from SEC staff for registrants, and ultimately perhaps more significant enforcement actions. Auditors will also likely be keen to evaluate compliance in this area.

The SEC has now received filings under the new standards, and comment letters issued to registrants give some indication of the agency's views of the adequacy of the initial disclosures.

⁵² Id.

⁵³ Id.

⁵⁴ Item 303(a)(5) of SEC Regulation S-K.

⁵⁵ Remarks of Joseph Ucuzoglu, senior accounting fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, webcast, *Perspectives on FIN 48—What's Next*, Tax Council Policy Institute, Washington, D.C., July 12, 2007.

⁵⁶ FSP FIN 49-d, Paragraphs 10, A1.

The procedures in the normal course start in the Division of Corporate Finance, which reviews the filings, issues comment letters, and after several rounds of questions and follow-up responses, the division may involve the Office of the Chief Accountant to help develop what the policy position will be on particular issues of significance.

As with other new accounting standards, there is a focus on FIN 48 disclosures—questions about what is and what is not disclosed given what would be expected under the requirements of the new standard.⁵⁷ Some of the comments that have been made so far include:

■ **Mattel Inc. 12/6/06 [prior to effective date of FIN 48].** “We note your disclosure that in 2005 you reduced your income tax reserves by \$38.6 million as a result of tax settlements reached with various tax authorities and reassessments of tax exposures based on the status of current audits in various jurisdictions around the world. Please revise your disclosure in future filings to provide more detail as to how you determine the amount to be reserved for uncertain tax positions. Also, provide us an analysis as of December 31, 2005 for the liability for estimated federal, state and international audit adjustments. As part of your analysis, describe for us in detail the significant issues that comprise the liability, tell us the amount recorded for each issue, explain to us how the amount was calculated, tell us the year to which the recorded amount relates, and tell us when the amount was recorded. Additionally, please revise your disclosure in future filings to more fully discuss the nature of any significant amounts included in the tax reserve.”

■ **Laboratory Corporation of America Holdings 7/19/07.** “We note your disclosures regarding the adoption of FIN 48 as of January 1, 2007. Please revise your disclosure to address whether it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date. Identify the nature of any uncertainties, the nature of the events that could occur within the next 12 months that could cause the amounts to change, and provide an estimate of the range of the reasonably possible change or state that an estimate of the range cannot be made. Refer to paragraph 21(d) of FIN 48 and the AICPA’s February 2007 FIN 48 disclosure summary, which sets forth Staff views with respect to these disclosures in the initial interim period of adoption. We note that no disclosure was made regarding material changes in contractual obligations from the amounts that were previously reported in your Form 10-K for the year ended December 31, 2006. Please tell us how you evaluated Instruction 7 to Item 303(b) of Regulation S-K with respect to contractual obligations relating to FIN 48. We note that it does not appear that your prior disclosure of contractual obligations included amounts relating to uncertain tax positions, and we believe that such amounts represent contractual ob-

ligations that should be included in the disclosures made under Item 303(a)(5) of Regulation S-K.”

■ **McDermott International Inc. 11/30/07.** “We note your disclosure regarding the \$70 million of unrecognized income tax benefits as well as accrued interest and penalties of \$27 million. Please revise future filings to clarify where you have classified these items on your balance sheet and tell us how your classification complies with Paragraph 17 of FIN 48. Further tell us how you have considered the sufficiency of your contractual obligation table in your Form 10-K in light of these unrecognized tax benefits. Note that a narrative disclosure should be provided for any material effects of FIN 48 liabilities on the prior year end table of contractual obligations based on Instruction 7 to Regulation S-K Item 303(b) in your interim periods. Please revise future filings accordingly.”

■ **McAfee 5/28/08.** “We note that upon adoption of FIN 48 the Company recognized a decrease of \$125.6 million in the liability for unrecognized tax benefits. Please provide more insight as to the reasons for the benefit recognized upon adoption of FIN 48. For instance, tell us what threshold was applied in recognizing your tax liability prior to the adoption of FIN 48 and tell us to which tax positions these adjustments relate.”

■ **Utah Medical Products Inc. 6/6/08.** “We note your disclosure here that you recognize interest accrued related to unrecognized tax benefits in operating expenses. Please tell us how your accounting policy complies with paragraph 19 of FIN 48, or alternatively revise future filings to comply with paragraph 19 of FIN 48.”

■ **CA Inc. 7/31/08.** “Footnote 2 to your table of contractual obligations indicates that ‘other obligations’ includes \$55 million of estimated liabilities for unrecognized tax benefits. However, we note from your disclosure on page 99 that your liability for income taxes associated with uncertain tax positions was approximately \$280 million as of March 31, 2008. Please reconcile these amounts and tell us what consideration you gave to including or disclosing the full amount of your FIN 48 liabilities.”

■ **Sybase 1/12/09.** “We note your response to our prior comment 2 where you indicate that the Company has projected that no payments would be made during the next twelve months for any contingent obligation arising from your unrecognized tax benefits. You also indicate that the Company is unable to accurately estimate the timing of such payment and accordingly, you have excluded the unrecognized tax benefits from your contingent obligation table. Please note while management may apply its judgment in determining what items should be included or excluded from the table, if management’s judgment results in items being excluded then the accompanying footnotes should describe the nature of the items excluded and why they are excluded. Please revise your disclosures in future filings to include a discussion of the Company’s contingent obligations arising from your unrecognized tax benefits and the reasons such amounts were excluded from your contractual obligation table.”

Conclusion

The final installment of this series will offer suggested actions for companies affected by the new rules.

⁵⁷ Remarks of Joseph Ucuzoglu, senior accounting fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, webcast, *Perspectives on FIN 48—What’s Next*, Tax Council Policy Institute, Washington, D.C., July 12, 2007; and, Roundtable, *Key Issues in Tax Policy: Financial Reporting and Corporate Transparency*, Tax Analysts, July 13, 2007, Washington, D.C.

FIN 48—Now for Private and Public Entities: Suggested Current Actions for Companies

This is the last in the series of five articles. Having in previous installments examined lessons that can be drawn from public companies' filings under FIN 48, the operation of the new rules when applied to private entities, the impact of FIN 48 in business combinations and special entity status considerations for private entities, and disclosure-related provisions of U.S. accounting treatments for taxes and other contingent liabilities, in this article Murray offers suggested actions for companies affected by the new rules.

Company personnel charged with responsibility for monitoring and reporting under the standards of Financial Accounting Standards Board Interpretation No. 48—Accounting for Uncertainty in Income Taxes, An Interpretation of FASB Statement No. 109 (FIN 48), have a range of issues to consider.

Identify, Monitor Positions

Adoption of FIN 48 by an entity, or applying its requirements to particular transactions, requires a careful process of identifying and monitoring of material uncertain tax positions.

As tax positions are identified, they should be categorized as “highly certain,”¹ uncertain, or borderline immaterial. Uncertain tax positions are those other than highly certain positions and require additional analysis and documentation. Borderline immaterial positions are those tax positions that are not currently material but should be monitored in future periods as they may become material.

Careful consideration should be given to acquisitions and dispositions. In a disposition, the seller will often retain pre-sale tax exposures through an indemnification agreement. If the statutes of limitations are still open on the pre-sale years, these exposures should continue to be monitored in the analysis.

Subsequent events and newly acquired information may also require re-evaluation of previous decisions as to the recognition and measurement of tax positions reflected in the financial statements.

Document Information Available

As discussed above, FIN 48 is applied with respect to all information that is available at the date of the financial statements.

The files should carefully document that information, so that if subsequent judgments are made with respect to “new information,” it may be established that the new information upon which the changes are based was acquired after the date of the previous analysis (new business information, new information from tax examinations processes, new tax legislation, regulations, or case law, and so on).

¹ Highly certain tax positions are discussed in FIN 48, Paragraphs A19-A20, and involve virtually no tax risk.

Determine Materiality Thresholds

Key elements of the recognition and measurement analyses and the disclosures are the financial statement materiality thresholds:

- the baseline for considering a tax position in the initial recognition analysis;
- the materiality threshold for considering and making subsequent adjustments; and
- materiality thresholds applicable to particular disclosures required under FIN 48 and FAS 109.

These determinations should be documented, and should be discussed within the financial organization, with the audit committee if necessary, and in most cases with the external auditors to obtain necessary feedback and to prevent later surprise disagreements.

These initial determinations dictate the scope of the work, and may drive the determination of applicable units of account for testing positions and the catalogue of significant tax positions that must be analyzed in the current period and followed and tracked in subsequent periods.

Changes in materiality thresholds in subsequent periods should also be documented and discussed as well.

Consider Positions for Inclusion

Similarly, tax positions themselves may be material in one period and not in the next, or vice versa, as the relevant situations change.

Systems should be reviewed and adjusted as necessary to refresh the list of positions for inclusion in a particular period, and to ensure that tax positions are tracked from the initial consideration into subsequent periods for so long as necessary.

Document Technical Authorities

Technical authorities that support the analysis, and any administrative practices and precedents, should be documented. That documentation should also include any unfavorable law as well.

The documentation may in the case of some positions be as simple as lists and citations, but if the tax position is more significant, consideration should be given to inclusion of technical memoranda and opinions.

If the resources are available in the tax department, that documentation may be provided by internal staff. In some cases, again depending upon the specific cir-

Accounting Standards Update 2009-06 Issued by FASB Sept. 3

The Financial Accounting Standards Board issued Accounting Standards Update 2009-06 Sept. 3.

The ASU (an update to the FASB Accounting Standards Codification) adopted the substance of FASB Staff Position FIN 48-d that was discussed in earlier articles published in this series.

The Master Glossary definition of a “tax position” was amended in the ASC to include “[a]n entity’s status, including its status as a pass-through entity or a tax-exempt not-for-profit entity.” The adjustments to disclosures related to nonpublic and public entities were adopted as described in earlier articles of this series in ASC 740-10-50-15. The examples applicable to nonpublic entities contained in the draft FSP were adopted in ASC 740-10-55-223 through 55-229.

The board did not adjust the effective date of the application of FIN 48 (ASC 740-10) to affected entities discussed in earlier parts of this series. Further, it provided by insertion into 740-10-65-2 the following transition-related provisions:

For entities that are currently applying the standards for accounting for uncertainty in income taxes, the pending content that links to this paragraph shall be effective for interim and annual periods ending after September 15, 2009. For those entities that have deferred the application of accounting for uncertainty in income taxes in accordance with paragraph 740-10-65-1(e),¹ the pending content that links to this paragraph shall be effective upon adoption of those standards. The effective date guidance in 740-10-65-2(a)² does not affect the effective date guidance for certain nonpublic entities in paragraph 740-10-65-1. [Footnotes added.]

¹“The effective date of Interpretation 48 for entities meeting the conditions of and electing to use the deferral in FASB Staff Position FIN 48-3 is for annual financial statements for fiscal years beginning after December 15, 2008.”

²“For entities that are currently applying the standards for accounting for uncertainty in income taxes, the pending content that links to this paragraph shall be effective for interim and annual periods ending after September 15, 2009.”

circumstances including in some cases the perceptions of and the technical positions taken by the external audit firm on the issue, consideration should be given to obtaining these opinions from outside consultants and counsel.

Consider Commitment to Controversy

The recognition of a tax position is based upon a consideration of whether the taxpayer will sustain the benefit taken or expected to be taken in the tax return in a dispute with taxing authorities if the taxpayer takes the dispute to the court of last resort. It may be necessary to document that the company will take the process as far as necessary to sustain its belief in the position, including litigation and appeals if necessary.

That again may require more than a statement in the file. The fact that the issue has been identified by the Internal Revenue Service for litigation, or other external enforcement issues, may be relevant.

A careful consideration may require documentation of discussions within the financial organization, with the audit committee, and perhaps contractual arrangements with outside firms that would be involved in the administrative controversy, and if necessary the ultimate litigation of the issue.

Track Open Years

The open years for each tax jurisdiction should be determined, documented, and tracked. This analysis may drive determinations of positions that are effectively settled under FSP FIN 48-1.

This is not as easy as it may seem, and will require the application of judgment to a number of factors in individual circumstances.

Similarly, these considerations may drive the negotiations in those audit cycles that are proceeding to pro-

duce more clearly defined criteria for these determinations in respect to those years.

Document Measurement Process

The measurement process should be documented with care. As noted above, there may be more than one outcome that may be reasonably possible.

Determination of the basis for a settlement, and the value of it, may again require a number of facts and legal issues to be documented.

Consider External Auditor Needs

Consideration should be given in all appropriate cases to a discussion with the external auditors, as the audit firm may require specific representations of and from management when the audit is performed.

Update Policies and Procedures

The company’s accounting policies and procedures should be updated and documented. If applicable, relevant documentation under Section 404 of the Sarbanes-Oxley Act of 2002 should be updated.

Policies should be established for errors and corrections and compliance with FAS 154 and Securities and Exchange Commission SAB 108² when adjustments are necessary when making the transition from FAS 5 treatment and into adoption of FIN 48, and when encountered going forward from the initial determinations under FIN 48.

² Staff Accounting Bulletin No. 108, 17 CFR Part 211, relating to the process of quantifying financial statement misstatements.

Create Appropriate Segregated Files

File documentation should be reviewed with an eye to making sure that all relevant material is present and included in appropriate segregated files.

IRS at present generally views the documents in the FIN 48 working paper files as being tax accrual work papers subject to its “policy of restraint.”³ However, that policy continues to be “under review.”

Documents for which available privileges from disclosure are available should be carefully evaluated and segregated or otherwise prepared and filed with applicable law and privileged material policies (and document retention policies) in mind, perhaps in conjunction with law department personnel and/or outside counsel.

Consider Working With IRS

IRS continues to stress that some enterprises may want to work with the service to achieve certainty on tax positions as expeditiously as possible.⁴ As FIN 48

³ IRS in 2002 revised its “policy of restraint” with respect to requests for tax accrual work papers that has been carefully applied since *United States v. Arthur Young & Co.*, 465 U.S. 805; 104 S. Ct. 1495; 79 L.Ed. 2d 826 (1984), in an effort to deal with certain “listed” transactions. Announcement 2002-63, together with Office of Chief Counsel notices CC-2003-012 and CC-2004-010, whose provisions are set forth in Internal Revenue Manual 4.10.20, set out guidelines and procedures to be used by examinations personnel in connection with the service’s policy regarding requests in certain circumstances for tax accrual and other financial audit work papers relating to the tax reserve for deferred tax liabilities and to footnotes disclosing contingent tax liabilities appearing on audited financial statements. Then the IRS Office of Chief Counsel published advice memorandum AM 2007-0012, dated March 22, 2007, but released to the public June 8, 2007. The counsel memorandum addresses the issue of whether documents produced by the taxpayer and/or its auditors to substantiate the taxpayer’s uncertain tax positions in compliance with FIN 48 are included within the service’s interpretation of tax accrual work papers as provided in IRM Section 4.10.20.2 (2). The memorandum states that FIN 48 and the other FASB pronouncements articulate financial accounting and reporting requirements. However, neither FIN 48, nor other relevant FASB pronouncements, prescribe documentation requirements. Rather, the documentation requirements that taxpayers and their auditors must follow are established by the SEC, the Public Company Accounting Oversight Board, and the American Institute of Certified Public Accountants, and these documentation requirements remain unchanged by the issuance of FIN 48. Consequently, the memorandum concludes that documentation resulting from the issuance of FIN 48 is considered tax accrual work papers for purposes of IRM Section 4.10.20.2(2). The memorandum also contains a recap of the definitions of key terms that define exactly what kinds of documentation are subject (and by implication those not subject) to the long-standing policy of restraint that is under review, and that is so important in the minds of taxpayers and their counsel as they prepare and discuss the risk assessments and strategies that are contained in the documentation.

⁴ The IRS Large and Mid-Sized Business Division opened a special initiative in October 2006 that would permit interested taxpayers working on adoption of the new standards to achieve a “greatly accelerated examination and resolution before the end of their current financial statement accounting

interest and penalties are applied, the impacts of unrecognized tax positions will grow, perhaps in significant and material amounts, and early recognition of an issue may prove expedient.

Conclusion

It seems likely that the provisions of FIN 48 are to be applicable to both public and private entities in the near future.

Application of its provisions may demand additional resources, and cause changes to a number of internal accounting procedures. Information not public before may be required to be disclosed.

Preparation a few months from now of annual financial statements that are subject to the rules involves a review and analysis of the accumulated tax positions that are part of them. Private enterprises can benefit from the accumulated experience of public companies as they prepare for the issuance of these statements.

If not already under way, remember that it pays to start the overall FIN 48 compliance process sooner rather than later.

year of uncertain tax positions taken in filed returns and/or expected to be taken in tax returns yet to be filed The initiative is not intended to produce a different result in the resolution of tax issues than would obtain under the normal pace of examination and resolution, but simply to speed up the processes. . . .”

Taxpayers that issue certified financial statements under U.S. generally accepted accounting principles are eligible if they meet the eligibility requirements of prefiling agreements (the initiative is not available to promoters of listed transactions, or to taxpayers in litigation or who pose issues in or destined for litigation), and the initiative is targeted at taxpayers whose current financial accounting years end on or before March 31, 2007 (the request must be received no later than the day that is 45 days prior to the taxpayer’s financial statement year-end date).

Prefiling agreements are described in Revenue Procedure 2005-12, 2005 C.B. 206, updated in Rev. Proc. 2007-17, 2007-1 I.R.B. 227, Jan. 22, 2007.

In addition to this special initiative, the IRS LMSB Division has adopted other programs involving accelerated examinations and agreements (e.g., the Compliance Assurance Program or CAP) that would allow taxpayers to reach agreement with the IRS prior to filing returns, and others that allow expedited resolution of issues in filed returns that may or may not be under examination but may be administratively settled by a taxpayer (e.g., Early Referral to Appeals, Rev. Proc. 99-28, 1999-29 I.R.B. 1; Fast Track Appeals Settlement, Rev. Proc. 2003-40, 2003-1 C.B. 1044; Accelerated Issue Resolution, I.R.M. 4.45.15.4, Rev. Proc. 94-67, 1994-2 C.B. 800), or by an industry (the Industry Issue Resolution Program under I.R.M. 7.40.1, Rev. Proc. 2003-36, 2003-1 C.B. 859).

The IRS Small Business and Self-Employed Division has adopted Fast Track Appeals Settlement, Announcement 2006-61, I.R.B. 2006-36, Sept. 5, 2006. Similarly, the Office of Chief Counsel will rule on certain technical issues in the context of an examination or as a freestanding ruling request.

See Q&A #7, *FIN 48 Implications—LMSB Field Examiners’ Guide*, LMSB-04-0507-045, May 2007, available at <http://www.irs.gov/businesses/corporations/article/0,,id=171859,00.html>.

While such programs raise additional considerations to those raised here and may not be appropriate for other reasons, enterprises should consider whether such avenues afford necessary resolutions to issues raised by application of FIN 48.

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The views expressed herein are those of the author, and do not necessarily reflect the views of Grant Thornton LLP.