

Lifting the fog*

Accounting for uncertainty
in income taxes

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Introduction

In the normal course of business, companies often seek to reduce their overall tax burden and minimize or delay cash outflows for income taxes. For example, they may enter into tax-advantaged transactions, structure their businesses in a tax-efficient manner, or seek tax-optimized methods of transacting with affiliates and others. Yet even without these tax-motivated activities, the average corporate tax return will include numerous positions—inherent to the normal course of business—that are subject to significant and varied interpretation (e.g., common leasing and financing arrangements). This often results in uncertainty about whether a particular position taken on a tax return will ultimately withstand the scrutiny of the relevant taxing authority.

Further, because income taxes are self-assessed in most jurisdictions and tax returns may not be examined for a number of years, companies must evaluate for financial reporting purposes the likelihood that the benefits of tax positions will be sustained upon review by the taxing authority. Owing to a widely perceived lack of explicit, authoritative accounting guidance in this area, substantial diversity in the accounting for tax uncertainties has developed.

In July 2006, the Financial Accounting Standards Board (the FASB or Board) released an Interpretation that is intended to reduce diversity: *Accounting for Uncertainty in Income Taxes* (FIN 48 or the Interpretation). Under the Interpretation, companies' financial statements will reflect expected future tax consequences of uncertain tax positions.

The key points in the Interpretation are:

- A tax benefit may be reflected in the financial statements only if it is “more likely than not” that the company will be able to sustain the tax return position, based on its technical merits
- A tax benefit should be measured as the largest amount of benefit that is cumulatively greater than 50-percent likely to be realized

While promoting increased standardization of current practice, the Interpretation could have significant consequences for a large number of companies. Among those consequences, we expect:

- Less flexibility for management in determining reserves for tax exposures as compared to existing practices
- Increased transparency of tax exposures, which may trigger inquiries by analysts and could affect the behavior of taxing authorities; it may also lead to larger cash outlays for taxes, due to a diminished appetite for taking aggressive tax positions
- Greater income statement volatility and increased risk of non-recurring financial statement effects from income taxes as management's assessments of uncertain tax positions change over time

This document discusses the Interpretation and highlights its most significant consequences for identifying, recognizing, and measuring uncertain tax positions. It also describes the new disclosures that are likely to increase the spotlight on uncertain tax positions, the accounting for changes in subsequent periods, the treatment of interest and penalties, balance sheet classifications, and internal controls. Further, it offers insights and considerations for effectively navigating this new guidance.

Identifying uncertain tax positions

To apply effectively the FASB's new and detailed guidance, companies will need to identify all significant income tax exposures existing as of the adoption date, including all uncertain positions in all tax years still subject to assessment or challenge under relevant tax statutes. Management must also ensure its ability to track such positions and maintain controls that can identify any impending transactions and positions. Undoubtedly, this will increase the burden on those responsible for income tax accounting and create a significant challenge for many businesses, particularly those that operate across borders. Multinational companies are typically subject to multiple tax jurisdictions—each with its idiosyncratic tax system and interpretation of the written tax code, and with personnel differing in culture, experience, and training.

As one of the first steps in identifying uncertain tax positions, a company must determine the appropriate “unit of account” or level of disaggregation of its tax positions and comprehensively analyze each disaggregated position. A common example is the uncertain sustainability of the eligibility for a tax credit of particular costs associated with research and experimentation activities. Should a tax position be identified and analyzed in the aggregate or should it be disaggregated—e.g., all research projects collectively or each project separately? Should the type of costs incurred for a particular project constitute the appropriate level of analysis or should every identifiable expense item be independently evaluated? Deciding not to provide definitive application guidance on these questions, the Board maintains that the specific facts and circumstances accompanying each position should be considered.

As explored in the following section, the determination of the unit of account can significantly impact the level of required tax reserves. For this reason, management will do well to focus on this determination as it develops processes and policies under the new Interpretation.

Recognizing uncertain tax positions

After uncertain tax positions are identified, the question becomes one of recognition: when, if ever, should the benefit of a tax position that reduces current or expected corporate tax burdens be recognized for financial reporting purposes? The new model prescribed by the Board answers this question in two steps. The first involves a recognition threshold that must be satisfied before any potential benefit can be recognized; the second focuses on measurement, a critical issue to be addressed in the next section.

Before it can qualify for benefit recognition, a position needs to have a “more likely than not” chance of being accepted on its technical merits by the relevant taxing authorities. Assuming that the taxing authorities have full knowledge of all relevant facts, management must be able to reasonably conclude that tax law, case law, regulations, and other relevant information provide sufficient evidence that the sustainability of the position is more than 50-percent likely. If that is not the case, the entire tax benefit provided by the position must be reserved in the financial statements.

Recognizing a reserve for an entire tax benefit could result in a recorded liability that is substantially greater than the eventual cash payment to taxing authorities. This, in turn, could adversely impact debt ratios and increase reported interest expense. It may also cause increased periodic effective tax rates because certain structures and recurring transactions may be deemed insufficiently sustainable and could affect reported income in future periods as the dispute resolution process unfolds.

The new recognition threshold also represents a significant change in current taxpayers’ accounting policies, which provide for notably lower or higher recognition thresholds in many circumstances. One of these policies allows a tax benefit to be recognized as long as it is not probable that it would be disallowed, while a second, at the other end of the spectrum, allows benefits to be recognized only if the sustainability of the benefit is considered probable. Depending on its historical policy and profile of positions, upon adoption a company may need to record substantially higher reserves or release significant amounts of currently existing tax reserves. Further, management should consider the expected effects of the Interpretation on the company’s system of internal control, as well as on budgeting processes, setting financial targets, communicating with capital markets, and negotiating the terms of any applicable contracts such as debt covenants.

Measuring the tax benefit

After concluding that a particular filing position has a “more likely than not” chance of being sustained, a company should address step two in the FASB’s model by measuring the amount of benefit to be recognized. To avoid potentially aberrant results and to create definitive guidance, the Board introduced a new methodology based on “cumulative probability,” a measurement approach under which companies will record in the financial statements the largest benefit that cumulatively is greater than 50-percent likely to be sustained.

This method is best understood through an example. Assume that a position to claim a tax credit of \$1,000 is “more likely than not,” based on its technical merits. The company seeking to claim this credit has developed the probability table, as shown below, of all possible material outcomes. Under the Interpretation, \$600 denotes the amount of tax benefit that would be recognized in the financial statements; it represents the maximum amount of benefit that is more than 50-percent likely to be the end result.

While maintaining such a table may not be necessary for positions for which a single amount is perceived as more than 50-percent likely, a table may be necessary when there are a number of possible outcomes with reasonable probabilities for a material tax exposure. A tremendous undertaking for many enterprises, this could prove to be a sensitive topic and a potential source of debate within a company and also among the company and its advisors and auditors. To minimize disagreement, companies should maintain a rigorous assessment process with substantial documentation of the underlying rationale for each decision.

Probability table:

Amount of the “as filed” tax benefit that management expects to sustain	\$1,000	\$800	\$600	\$400	\$200
Percentage likelihood that the tax position will be sustained at this level	10%	20%	25%	25%	20%
Cumulative probability that the tax position will be sustained	10%	30%	55%	80%	100%

Disclosures

While management may be concerned about providing taxing authorities with information that is helpful for their enforcement activities, other stakeholders—for example, investors and regulators—use the same set of financial statements for their own purposes. Accordingly, there can be substantial divergence in expectations among concerned parties regarding the depth of disclosure relative to tax exposures.

The Interpretation addresses this issue by requiring a discussion of positions expected by management to change significantly within the next 12 months and a quantitative roll-forward of the worldwide, aggregated amount of unrecognized tax benefits. The tabular reconciliation of the beginning and ending balance of unrecognized tax benefits from uncertain positions will include line items such as the effects of new positions taken during the year, changes in assessments of prior-period positions, and the impact of settlements with taxing authorities (see example below). The FASB believes that this aggregated level of information will not provide the taxing authorities with new or additional meaningful information for their enforcement efforts, but will allow users of the financial statements to make judgments about management's risk appetite, as well as possible future cash outflows of resources, and identify significant changes in management's estimates. Companies will want to consider the need to communicate with analysts and other interested parties about specific adjustments in the roll-forward disclosure.

Companies should also be cognizant of the possible impact of the new accounting model and the related disclosure requirements on their relationships with the taxing authorities. For example, disclosing the expected release of a significant tax reserve within the next 12 months may affect the company's negotiating position with the taxing authorities or result in increased attention by taxing authorities during an ongoing or future tax examination. Notwithstanding those concerns, disclosure is required under FIN 48 when the change is expected to be significant. Accordingly, companies will want to consider how best to satisfy the disclosure requirements of FIN 48, while at the same time balancing such concerns.

	(in thousands)
Balance, January 1, 2007	\$ 145,000
Additions for tax positions of the current year	5,000
Additions for tax positions of prior years	10,000
Reductions for tax positions of prior years for:	
<i>Changes in judgement</i>	(23,000)
<i>Settlements during the period</i>	(15,000)
<i>Lapses of applicable statute of limitation</i>	(12,000)
Balance, December 31, 2007	\$ 110,000

Changes in subsequent periods

Under the Interpretation, the assessment of uncertain positions is a continuous process; it does not end with the initial determination of sustainability or benefit. Companies will need to implement processes and controls that identify material changes in the assessment of open positions, whether they result from case law developments, tax law changes, regulations issued by taxing authorities, or the dispute resolution process. Such developments could change the amount expected to be sustained or cause a position to cross the recognition threshold, thus switching a classification from sustainable to unsustainable or from unsustainable to sufficiently sustainable. Any changes in the tax liability for uncertain positions taken in prior fiscal years would be recorded as a discrete event in the period in which management's estimate or assessment changes.

This new procedure significantly alters current methodology. Practice prior to FIN 48 commonly categorized positions that initially failed to meet the recognition threshold as contingent gains and did not allow benefit recognition when they subsequently achieved a sufficient level of sustainability. Instead, these positions remained unrecognized until realized (e.g., at the closing of a tax audit or expiration of the limitation statute).

The requirement to regularly review the sustainability and measurement of all material positions could substantially increase the tax department's involvement in financial reporting and require significant coordination between finance, tax, legal, and operational units of a company. Management should consider the potential financial reporting consequences of tax developments and should be cognizant of the various "early warning" disclosure requirements for public entities (e.g., Form 8-K requirements or discussion of expected significant near-term changes).

The required continuous reassessment of positions will entail substantial judgment to reach conclusions, often based on limited information; this may complicate relationships among companies and their auditors. Auditors often have limited information with which to assess management's assertions and judgments, and their questioning, although appropriate and necessary, will require an understanding management. Additionally, in many jurisdictions the resolution process for a challenged tax position involves several stages at which a previous finding that may have been advantageous to the company could potentially be overturned.

At what point in the resolution process can management rest assured? What stage provides sufficient evidence for recognition of the reserved tax benefit? By and large, we believe that, prior to ultimate resolution, a change in the amount of benefit expected to be sustained would be infrequent and would likely result only from an identifiable, discrete event, such as a specific communication with relevant levels at the taxing authority, the resolution of an analogous court case, or a change in regulations or other applicable guidance.

Interest and penalties

Interest and penalties to be paid to taxing authorities for underpayment of tax liabilities could be regarded by the company as a separate contingent obligation. For instance, even if the filing position does not meet the “more likely than not” threshold, the company may expect to settle at 30 to 40 percent of the position’s value and, therefore, would not anticipate payment of interest on the entire recorded tax liability. However, implicit in the Interpretation is the notion that a benefit claimed on a tax return that does not qualify for financial reporting recognition effectively constitutes a government loan and/or misapplication of tax law, which could result, respectively, in an interest charge and/or a potential penalty. In light of this, the Board concluded that interest should be accrued on the entire balance of the liability for unrecognized, uncertain tax benefits and not on a reduced amount reflecting management’s expectation that the liability may be resolved at less than the full amount. According to the Interpretation, penalties should be accrued in accordance with relevant tax law when a position does not meet the minimum statutory threshold for avoiding payment of such penalties.

Balance sheet classification

The analysis of tax positions and related interest and penalty exposures will usually result in the recognition either of a tax liability or, in certain circumstances, a decrease in recognized tax assets on the balance sheet—for example, a claimed but unsustainable deduction that created a net-operating-loss position and a corresponding deferred tax asset.

The tax liability recorded for uncertain positions is not a component of deferred taxes and must be classified separately from other tax balances, based on the expected timing of cash flows to or from taxing authorities. Generally, the journey from audit to resolution spans several years, hence the classification of these liabilities as long-term. If management expects a payment within the next 12-month period, an amount equal to the expected cash payment should be reclassified as a short-term liability.

Impact on internal controls

The detailed assessment of the probability of success and the measurement of the amount expected to be sustained will require explicit documentation by companies and may also require an update of current legal opinions on pre-existing tax positions. Management should develop a process that supports reliable identification and consistent analysis and assessment of material exposures in all relevant, and often numerous, taxing jurisdictions.

The Interpretation represents a significant shift in the accounting and reporting model for income taxes, yet its effects are likely to go well beyond merely changing reported balances in financial statements. Further, it introduces a more defined, rigorous accounting model while requiring significant judgment by management. The level of implementation effort and need for process changes should not be underestimated, particularly for multinational companies. Senior management and the board will want to consider:

- Whether the company has the necessary resources, such as sufficient personnel with adequate experience and training, as well as information collection and management processes, to implement and comply with FIN 48 in a timely manner
- The strength of the company's tax-related internal controls and what modifications may have to be developed and implemented
- Current tax-related policies and disclosure practices, and the extent to which they may have to change upon adoption
- How adoption of FIN 48 will likely affect the company's key financial measures and what communications with other parties may be necessary (e.g., shareholders, analysts, others)

The many difficult assessments required in evaluating uncertain tax positions and their potential material impact on financial statements and other corporate communications will require a more profound interaction among finance, tax, legal, and operational units of a company, several of which may have diverging views and business objectives and may require mediation and guidance from senior management or the board of directors itself. To minimize unnecessary time spent on resolving disputes, management will want to ensure that the right mix of personnel is devoted to this effort from the outset.

Undeniably, uncertain tax positions create risk for companies. To minimize that risk, management and the company's board should ensure that their values and risk tolerance are properly communicated and understood by all corporate employees, including those who determine the level of risk the company will assume in tax return filings. Companies should allow their conscientiously formulated risk policy to guide complex decisions regarding which tax positions will be pursued to minimize taxes, how tax positions will be evaluated for financial reporting, and the quality of disclosures in financial statements.

