

More likely than not*

A comparison of FIN 48 and the tax penalty standard



More likely than not: A comparison of FIN 48 and the tax penalty standard

Authors:

Tiffany Mauldin¹

Edward Abahoonie²

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¹ Tiffany Mauldin is a Manager in the Atlanta, GA office of PricewaterhouseCoopers LLP, and recently completed a temporary assignment with the firm's National Tax Accounting Services practice.

² Edward Abahoonie is a Partner with PricewaterhouseCoopers LLP and Technical Leader of the firm's Tax Accounting Services practice.

Efforts intended to strengthen objectivity and transparency with respect to tax planning, compliance, and conflict resolution have converged around the use of a “more likely than not” standard. A spectrum of consequences may now depend upon whether a position taken, or expected to be taken, in a tax return is more likely than not to be sustained.

Yet, the definition and significance of more likely than not (“MLTN”) is not identical across the contexts in which it is applied. Accordingly, it is important to consider each context carefully, both to ensure consistency, where appropriate, and understand potential divergences that may exist.

Evolution of “more likely than not”

In June 2006, the Financial Accounting Standards Board (“FASB”) released FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48” or “the Interpretation”). Under the Interpretation, enterprises are required to assess an income tax position to determine whether the benefit of the position can be recognized in US GAAP financial statements. The benefit recognition threshold requires that the position be more likely than not to be sustained based upon its technical merit under applicable tax laws. This threshold or standard is defined as a likelihood of more than 50 percent. A position meeting the MLTN standard must then be measured to determine the amount that is recorded in the financial statements. The application of FIN 48 requires an assumption that the taxing authority will be aware of all relevant information and perform an appropriate examination of the position.

While FIN 48’s MTLN standard has received considerable attention, it is but one of a growing number of uses of a MTLN standard by various standard setters, regulatory authorities and policy makers.

The U.S. Department of Treasury Circular 230 regulations govern the practice of CPAs, lawyers, enrolled agents, and enrolled actuaries (“practitioners”) before the Internal Revenue Service. In various specified circumstances, Circular 230 requires that a MLTN standard be met for written tax advice that may be relied upon by a taxpayer for penalty protection. The scope of this rule includes transactions having a significant tax planning purpose.

Another MLTN usage was adopted by the Public Company Accounting Oversight Board (“PCAOB”) in Rule 3522, released in June 2006. Pursuant to Rule 3522, a registered public accounting firm is prohibited from providing service to an audit client that involves marketing, planning, or opining in the favor of an “aggressive tax position.” The PCAOB rule defines an aggressive tax position as a position “that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.” A violation of this rule results in the impairment of independence by the audit firm.

Most recently, a MLTN standard was made broadly applicable to tax return preparers (including advisors who are considered non-signing preparers) in revisions to Internal Revenue Code Section 6694. Under the Small Business and Work Opportunity Tax Act of 2007, IRC Section 6694 was revised to increase the preparer standard for tax return positions. A position that is not adequately disclosed must generally meet a MLTN standard for the preparer to avoid penalty. The standard applies not only to an outside preparer signing the return, but may apply to any outside advisor being compensated for providing guidance on a significant tax position within a return. For example, a law firm providing an opinion on the tax treatment of a transaction could be subject to the penalty, should the position be determined to not meet the MLTN standard and to not have been adequately disclosed.

In some circumstances, a tax preparer can avoid penalty assessment under IRC Section 6694 if it can be shown that there is reasonable cause for the understatement and that the preparer acted in good faith. The penalty standard also allows a preparer to rely in good faith upon information or analysis provided by the taxpayer or other advisors.

The MLTN penalty standard also applies (even prior to the recent revision of IRC Section 6694) in determining whether a taxpayer is subject to penalty under IRC Section 6662 for tax positions that are scoped into the so-called “tax shelter” rule. Such positions, defined generally as those involving significant tax planning, must satisfy the MLTN standard in order for the taxpayer to avoid penalty assessment.

There is a divergence in the applicable scope of the taxpayer and preparer MLTN standard; the taxpayer requirement only applies in the “tax shelter” context, whereas the preparer standard applies without such limitation. A number of legislative proposals have been introduced to reduce or eliminate the divergence.

Tax preparers should also be aware of the state laws governing preparer penalties. Some states may choose to conform to the Internal Revenue Code, while other states may provide a separate tax preparer penalty in their laws. For example, California and New York previously incorporated a MLTN standard in state penalty statutes applicable to preparers.

FIN 48 and the tax penalty standard

Perhaps the most sweeping and consequential applications of a MLTN standard are those required by FIN 48 and the aforementioned federal tax penalty rules. These requirements have been considered by many to be controversial, due to the sensitive balance among potentially competing interests. There are responsibilities requiring levels of disclosure to users of financial information, coupled with ethical expectations embedded in a system of voluntary tax compliance. There are responsibilities to properly manage one’s tax affairs and principles of fairness in relation to confidentiality and the conduct of conflict resolution with taxing authorities.

In broad terms, the respective MLTN standards are directionally aligned both in concept and with respect to certain key parameters of application. Both standards apply to positions taken in originally filed returns, amended returns and refund claims. Both require assessment of the technical merits of a position, without consideration of the probability of a review by the taxing authority. Similarly, prospects of settlement, compromise or the trading of issues or positions with taxing authorities are not considered. Both standards look to a general framework of adjudication by considering how a court might decide on the position.

Nonetheless, careful analysis of each reveals interesting and potentially significant differences that should be considered in their implementation as well as by users or reviewers of the resulting information. Differences between the respective standards can result in what may appear to be inconsistent outcomes when in fact the outcomes reflect proper compliance with both standards.

The following table highlights some of the potential differences between the scope or operation of FIN 48 and IRC Section 6694. While the preparer penalty provision is used for this illustrative purpose, it should be noted that many of the points would similarly relate to the respective IRC Section 6662 and Circular 230 standards. The table may be a helpful guide or starting point for understanding how and why there may be differing outcomes in the respective contexts.

	FIN 48	IRC Section 6694
First years affected	For public enterprises, adoption required for fiscal years beginning after December 15, 2006. For nonpublic enterprises, adoption required for annual financial statements for fiscal years beginning after December 15, 2007.	Original or amended tax returns filed on or after January 1, 2008, or, in the case of excise and payroll tax returns, February 1, 2008.
Applicable taxes	Applies to income-based taxes under the definition of FAS 109.	Applies to any tax reported on a tax return under any title of the Internal Revenue Code.
Reporting period	A position may be taken into account in a period prior to its inclusion in a tax return.	A position is considered to be taken when included in a tax return filed with the taxing authority.
Applicable party	Positions may be considered those of an entity that is not the actual taxpayer as a result of financial accounting principles relating to consolidation, indemnification or tax-sharing agreements.	Applies to positions of the taxpayer, based upon the definition of taxpayer under the Internal Revenue Code.
Flow-through entities	Generally applies to tax positions reflected at the partner, shareholder or owner level; however, would also apply at the entity level to entity tax status classification issues.	Applies at the entity (including partnership) level, as well as the partner, shareholder, or owner level.
NOLs and carryforwards	Applicable regardless of an NOL or carryforward being generated.	In effect, applicable when loss or credit utilization occurs.
Returns not filed	A decision not to file a tax return is a tax position subject to the standard.	Applies to tax positions on filed tax returns or refund claims.
Materiality	Enterprises must assess all material tax positions.	No broadly applicable concept of materiality.
Assessment framework	Applies a two-step method for assessing income tax positions: recognition and measurement.	No specific guidance or comparable framework.

	FIN 48	IRC Section 6694
Unit of account	The level of technical issue identification that is subject to MLTN assessment. The determination of the unit of account is a judgment required of an enterprise's management.	No specific guidance or comparable framework.
Basis of conclusion	The conclusion of MLTN depends upon the enterprise's point of view, which is subject to assessment by the independent auditor.	The conclusion of MLTN is based upon the judgment of the tax return preparer.
Consideration of judicial process	The MLTN assessment is made on the assumption that the court of last resort would review the position, without consideration of the probability of such a review occurring.	No specific guidance.
Timing items	Timing items are generally considered to have met the recognition requirement.	No specific guidance or comparable framework.
Administrative practices	Positions that are deemed to be "widely understood" as acceptable to the taxing authority are considered to have met the recognition requirement.	No broadly applicable concept permitting consideration of administrative practices.
Subjective reliance	No standard provided related to good faith reliance or reasonable cause.	Tax return preparer may rely in good faith on information provided by taxpayer and other advisors and also rely upon reasonable cause to avoid penalty.
External advisors	The standards of recognition and measurement apply to the enterprise and may be assessed by management without the counsel of an external advisor.	The penalty applies to the external tax return preparer(s), including non-signing preparers.
Partial reserves	May result from the measurement phase of the two-step method when an enterprise is not able to record the entire tax benefit of the position for financial reporting purposes.	Not applicable.
Effective settlement	Benefit recognized in financial statements for positions that are considered effectively settled.	Not applicable.

As the table illustrates, in some respects the FIN 48 framework and its application to tax positions is more thoroughly articulated than the tax penalty standard. FIN 48 applies to a very broad population of enterprises and has been the subject of considerable experience. The implementation of FIN 48 has required comprehensive data gathering and analysis. In turn, such processes resulted in the identification of probing and detailed questions, leading to the development of considerable guidance.

The guidance and depth and breadth of experience with FIN 48 may be useful to reflect upon in addressing tax penalty standard questions. Taxing authorities and tax policy makers may wish to consider such guidance, at least as a starting point, for assessing tax positions under tax penalty standards. For example, clarity and consistency could be achieved by applying FIN 48 principles with respect to timing items and taxing authority administrative practices in the penalty context.

Further observations

It is increasingly important for taxpayers and professional service providers to document the facts and circumstances used in reaching conclusions of MLTN with respect to tax positions. Outside tax advisors and return preparers must use reasonable effort and diligence to develop a full set of facts used to conclude on tax positions. That may include, or be supported by, representations or confirmations from management with respect to the facts presented. Workpapers and documentation of conclusions need to be robust, and a taxpayer's internal controls must operate to help ensure both proper tax compliance and financial reporting.

Independent auditors review and opine on the fair presentation, in conformity with US GAAP, of a company's financial statements. As part of an audit, the FIN 48 judgments and assessments of the enterprise are reviewed by the independent auditor. This review can be expected to include the review of documentation including opinions, memoranda, correspondence, and calculations with respect to tax positions that have been prepared or reviewed by outside advisors.

As a result of the tax penalty standard and Circular 230, outside tax preparers and advisors are required to more frequently communicate requirements for disclosure to taxpayers, in order to ensure protection from penalty risk. Independent auditors will keep in mind such communications that taxpayers may receive as those communications can be important audit evidence. Such views may need to be considered for purposes of FIN 48 (or other applicable) tax uncertainties assessments. Further, it will be important to consider positions disclosed, or expected to be disclosed, for penalty protection purposes in the tax return. As discussed, while the respective scope and application of FIN 48 and the penalty standard are similar in some respects, there are also many significant differences. It is important to understand the consideration of all such information in making a complete assessment of FIN 48 judgments and measurements.

Outside tax return preparers, particularly signing preparers, might be expected to consider a company's FIN 48 assessments as indicating that disclosure in the tax return may be required. Preparers may request information from a company in order to ensure that all tax positions not meeting the MLTN standard for FIN 48 purposes are accurately presented or disclosed in the tax returns. At the same time, however, there may be reluctance to provide such workpapers or assessments due to concerns regarding confidentiality or privilege protections the enterprise asserts with regard to such information. A taxpayer may be concerned that sharing such information with a tax preparer would cause protections to be waived, thereby enabling the taxing authority to gain access to the information. The elements of the various potential privileges or protections continue to be debated and contested by taxpayers and the taxing authorities, and it is expected to remain an area of keen sensitivity.

The convergence around use of a MLTN standard with respect to the interpretation and application of tax laws has clearly arrived. It affects the responsibilities of virtually all members of the tax and accounting professional communities. For taxpayers, it presents unique strategic and risk management challenges. For users of the resulting information and for regulators seeking to strengthen the quality and consistency of such information, it presents challenges to reaching informed conclusions and providing responsive further guidance as needed. All participants in the respective reporting channels must continue to demonstrate the agility required to successfully manage these significant reforms in tax and financial reporting.

Contacts

For more information on the topics discussed in this thought leadership piece or for other tax accounting questions, please contact your local PricewaterhouseCoopers engagement team member or your local Tax Accounting Services network member listed in the table below.

US Leader	Dean Schuckman	(646) 471-5687
Atlanta/Birmingham/Nashville	Ben Stanga	(678) 419-1243
Boston/Hartford	John Renterghem	(617) 530-5143
Charlotte/Raleigh	Roy Strowd	(704) 344-7828
Chicago/Milwaukee	Ken Kuykendall	(312) 298-2546
Cincinnati/Columbus/Dayton/Indianapolis	Dan Staley	(513) 723-4727
Dallas/Austin/Fort Worth	Steve Schoonmaker	(214) 754-7418
Denver/Salt Lake City	Mike Braun	(720) 931-7289
Detroit/Grand Rapids/Toledo	Jim Dugan	(313) 394-6242
Houston/New Orleans/Tulsa	Niloufar Molavi	(713) 356-6002
Los Angeles/Las Vegas/Orange County/Phoenix/San Diego	James Damato	(213) 830-8244
Miami/Orlando/Tampa	George Baccash	(305) 347-3584
Minneapolis	Jeff Bjustrom	(612) 596-4748
New York/Florham Park/Stamford	David Merl	(646) 471-5741
Philadelphia/Harrisburg	Diane Place	(267) 330-6205
Pittsburgh/Cleveland/Rochester	Mike Tomera	(412) 355-6095
San Francisco/San Jose/Sacramento	Rich Johnson	(408) 817-7483
Seattle/Portland	Steve Terry	(971) 544-4479
St. Louis/Kansas City	Brian Sprick	(314) 206-8509
Washington DC/Baltimore/Richmond	James Grow	(703) 918-3458

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