

### **FIN 48: Accounting for Uncertainty in Income Taxes** **An interpretation of FASB statement no. 109**

**October 26, 2007**

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**Alert Number: 07-02**

FIN 48, “*Accounting for Uncertainty in Income Taxes*”, has potentially significant ramifications for captive insurance companies that have made an IRC Section 953(d) election to treat the company as a domestic insurance company for US federal income tax purposes.

The interpretation of FIN 48 consists of two main points:

- A tax benefit/expense may be reflected in the financial statements only if it is “more likely than not” that the company will be able to sustain the uncertain tax position (“UTP”), based on its technical merits (there is no consideration of detection risk by the relevant taxing authorities, known as the “if all facts were known” standard); and
- A tax benefit/expense should be measured as the largest amount of benefit/expense that is cumulatively greater than 50 percent likely to be realized (the two step process known as “Recognition and Measurement”).

FIN 48 also provides guidance on transition, derecognition, classification, interest & penalties, accounting in interim periods, and disclosure.

#### **Effective date**

- This standard is effective for all fiscal years beginning after December 15, 2006.

#### **Purpose**

- FIN 48 will result in increased relevance and comparability in financial reporting of income taxes by implementing a consistent criteria for the recognition, derecognition, and measurement of income tax assets and liabilities.
- The new standard amends and replaces certain requirements of FAS 5, “*Accounting for Contingencies*” and FAS 109, “*Accounting for Income Taxes*”.

#### **Captive context:**

Given the judicial history of captive insurance companies one would expect that the tax treatment of transactions with a related party would fall into the UTP category.

The implications of FIN 48 should have already been considered by the relevant group level tax department, and the potential impact on the captive may well have been considered immaterial for purposes of the parent’s consolidated accounts. However, when producing stand-alone accounts for the captive, the implications of FIN 48 must be separately considered for the captive entity and consultation undertaken to ensure that the appropriate assessment and disclosures are included in the captive’s financial statements.

The objective of FIN 48 is to clarify the criteria and eliminate the diversity that exists for recognition of UTP while promoting increased standardization of current practice. FIN 48 could have significant consequences for a large number of captive insurance companies including (but not limited to):

- Whether the transactions with the captive qualify as “insurance” for US federal income tax purposes;
- Whether the captive meets the definition of an “insurance company” for US federal income tax purposes;

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- Whether the captive's IRC 953 (d) or IRC 953(c)(3)(C) elections are valid;
- Whether the loss reserves booked by the captive are "fair and reasonable"; and
- Whether there is an impact of the loan-back of significant assets to related affiliates on the tax status of the captive.

### Implications:

What does it mean?

- If the captive can't support the tax assertions, maybe they should take a credit for taxes incurred since the election may be invalid (therefore US GAAP financials issue);
- If the captive is material to the group, it may have an impact on group tax presentation and UTP disclosure (FIN 48 and SAB 74); and
- The net effect on group is the loss of deferral of tax on loss reserves.

### Qualitative considerations

- Annual assessment of more-likely-than not recognition criteria.
- Update notes for required disclosures:
  - Disclosure policy on classification of interest; and
  - A description of the tax years which remain subject to examination by major tax jurisdictions.
- Where it is reasonably possible that the total amounts of UTB will significantly increase or decrease within 12 months of reporting date, disclose:
  - Nature of the uncertainty;
  - Nature of the event occurring within next 12 months that could cause change; and
  - An estimate of the range of the reasonably possible change or a statement that a range cannot be made.

### Quantitative considerations

- Disclosure for the year of adoption only:
  - The cumulative effect of the change on retained earnings as at the date of adoption (as a result of the requirement that opening retained earnings be adjusted in a separate line item on the balance sheet for the effect of applying FIN 48).
- Tabular reconciliation of the total unrecognized tax benefit at beginning of period to the end, including:
  - Gross increases/decreases in unrecognized tax benefits ("UTB") as a result of positions from prior periods;
  - Gross increases/decreases in UTB as a result of positions from current period;
  - Reductions in UTB relating to settlements with taxing authorities;
  - Reductions in UTB relating to lapse of applicable statute of limitations.
- Total amount of UTB that, if recognized, would affect the effective tax rate.
- Total amounts of interest and penalties recognized on each of the income statement and balance sheet.

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