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FIN 48 – How to Navigate...

**Tax Accounting Challenges in Today's
Environment**

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This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding tax penalties that may be imposed on the taxpayer.

Agenda



- I. Introduction**
- II. Client Action Plan – Tax Practical Considerations**
- III. Tax Accounting Areas requiring Examination**
- IV. Subsidiaries - Main Challenges**
- V. Q&As**
- VI. PwC Tel-Aviv FIN 48 Tax Team – Main Contacts**



I. Introduction

FIN 48 Introduction

Main Purposes – Practical Aspects



- The intense growth in reporting obligations and scrutiny requires companies to comply with an enormous amount of different rules and guidelines.
- The recent introduction of FIN 48 has strengthened this “trend”, allowing companies with a limited timeline to align their tax & accounting approaches and procedures with the specific requirements of FIN 48.

FIN 48 Introduction

Main relevant Terms



- **Tax Position** – Position in a previously filed tax return or expected to be taken in a future tax return
- **Recognition** – “More-likely-than-not” based on technical merits – i.e., whether the position is supported by an “administrative practice or precedent” that is “widely understood”
- **Measurement** – Greatest amount of benefit cumulatively >50% likely of being realized
- **Unit of Account** - the level that the tax position is subject to challenge by taxing authority based upon facts and circumstances for each entity



II. Client Action Plan

FIN 48 Client Action Plan

Objectives



- Achieve FIN 48 reporting standards within a given time frame
- Design a manageable inter-group process for FIN 48 implementation
- Develop internal expertise for future on-going implementation of FIN 48
- Ascertain cost-efficient measures for companies in maintaining their FIN 48 compliance standards and working procedures, going forward

FIN 48 Client Action Plan

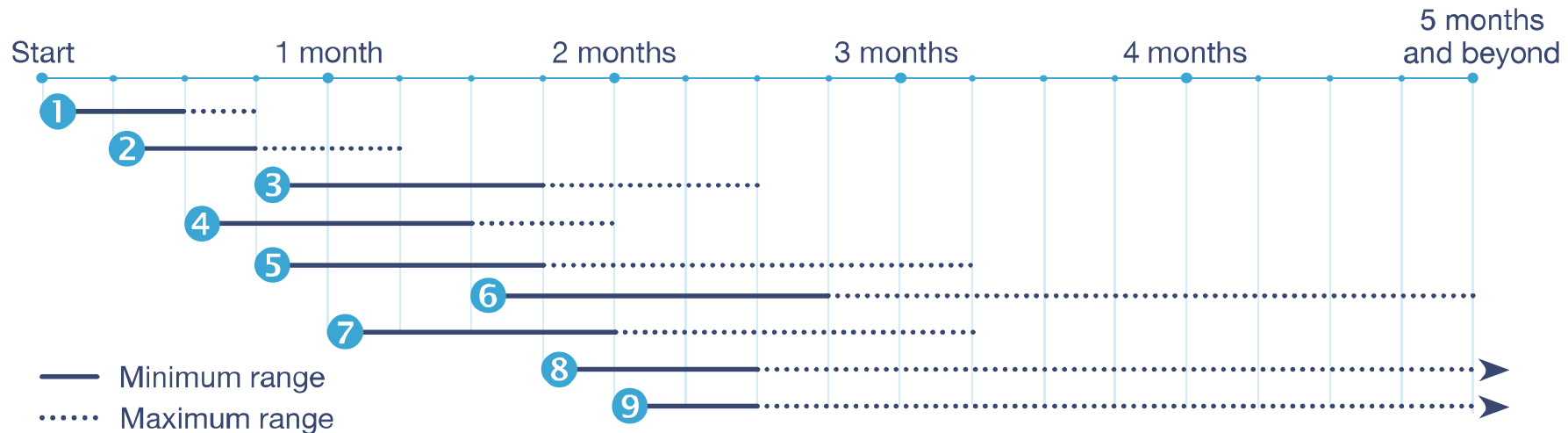
Implementation Aspects – Tax



- **Proposed time-table**
- **Preparation & “Kick-off”**
- **Identification of significant uncertain tax positions (“UTPs”)**
- **Assessment, Recognition, Measurement and development of supportive documentation**

FIN 48 – Client Action Plan

Proposed Time-table – main items



1. Internal communication and education
2. Formulation of implementation plan
3. Identification of all significant uncertain tax positions
4. Modify/develop accounting policies and processes affected by FIN 48
5. Assess and develop supporting documentation for uncertain tax positions
6. Prepare draft financial statement presentation and disclosures
7. Change and/or develop internal controls
8. Tax planning and tax examination management
9. Identify and determine appropriate resources and systems required for ongoing compliance with FIN 48

FIN 48 – Client Action Plan

Preparation & “Kick-off”



- Internal preparation – timing and schedule, staffing & advisors
- *Kick-off* meeting with advisors & auditing firm representatives
- Development of approaches and strategies
- Identification and prioritization of Tested Entities / Jurisdictions
- Crystallization of action plan, time table and allocation of responsibilities

FIN 48 – Client Action Plan

Identification of significant Uncertain Tax Positions (“UTPs”)



- Interviews with key personnel within company
- Consultation with external advisors (beneficial to interact with tax specialists who possess FIN 48 expertise)
- Scoping of “open-years”, returns under audit, etc.
- Identification of UTPs
- Preparation of a UTPs “Inventory list”
- End Result – Accumulation of identified UTPs in a template

FIN 48 – Client Action Plan

Identification of significant Uncertain Tax Positions (“UTPs”)



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		C	Q	AE	AS
		1st Qtr - 2006	2nd Qtr - 2006	3rd Qtr - 2006	4th Qtr - 2006
1	[No Company Name Entered!]	[Entity Not Entered]	[Entity Not Entered]	[Entity Not Entered]	[Entity Not Entered]
2	Potential FIN 48 Issues	[UTP Not Entered]	[UTP Not Entered]	[UTP Not Entered]	[UTP Not Entered]
3	Issue 2	Roll Forward	Roll Forward	Roll Forward	Roll Forward
4	FY Ending: 2006	Clear Quarter	Clear Quarter	Clear Quarter	Clear Quarter
5	Delete Issue	Show Probability Analysis	Show Probability Analysis	Show Probability Analysis	Show Probability Analysis
6	Add New Issue				
7	Unit of Account	[Unit of Account Not Entered]	[Unit of Account Not Entered]	[Unit of Account Not Entered]	[Unit of Account Not Entered]
8	Reference Number	[Reference Number Not Entered]	[Reference Number Not Entered]	[Reference Number Not Entered]	[Reference Number Not Entered]
9	Classification	[Classification Not Entered]	[Classification Not Entered]	[Classification Not Entered]	[Classification Not Entered]
10	F/S Classification	[F/S Classification Not Entered]	[F/S Classification Not Entered]	[F/S Classification Not Entered]	[F/S Classification Not Entered]
11	Tax Jurisdiction	[Tax Jurisdiction Not Entered]	[Tax Jurisdiction Not Entered]	[Tax Jurisdiction Not Entered]	[Tax Jurisdiction Not Entered]
12	Issue Under Audit (Y/N)	-Select-	-Select-	-Select-	-Select-
13	Date Statute Begins				
14	Date of Statute Expiration				
15	Statute Extension Date				
16	Likelihood of Success	-Select-	-Select-	-Select-	-Select-
17	Unrecognized Tax Position (LCU Gross Amount)				
18	Recognized Tax Benefit (Pre-Tax in LCU)	0	0	0	0
19	Unrecognized Tax Benefit (Pre-tax in LCU)	0	0	0	0
20	Applicable Enacted Tax Rate				
21	Unrecognized Tax Benefit (LCU Tax Effected)	0	0	0	0
22	FX Rate (USD per LCU)	1.0000	1.0000	1.0000	1.0000
23	Unrecognized Tax Benefit (in USD Tax Effected)	\$0	\$0	\$0	\$0
24	Interest (in USD)				
25	Penalties (in USD)				
26	Is it reasonably possible that the total amount of the UTP will significantly change within the next 12 months	-Select-	-Select-	-Select-	-Select-
27	Administrative Practice Rationale (if applicable)				
28	Analysis & Conclusion as to Unit of Account				
29	UTP Facts and Explanations				
30	Technical Analysis				
31	Conclusion as to Recognition				

Index / Roll-Fwd / Import Issue / Compare Qtrs / UTP Issue Summary / UTP Issue Sheet /

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FIN 48 – Client Action Plan

Assessment, Recognition, Measurement and development of supportive documentation



Assessment

- Internal assessment of UTPs
- Consultation with tax specialists
- Examination of audit history, professional opinions, letter rulings, etc.
- Accumulation of other relevant data

FIN 48 – Client Action Plan

Assessment, Recognition, Measurement and development of supportive documentation



Recognition

- Identification of Items that do not meet the recognition threshold level (i.e., the MLTN criteria)
- Determination of items that meets the recognition threshold criteria
- Determination of amounts of tax benefits cumulatively exceeding the MLTN criteria

FIN 48 - Client Action Plan

Assessment, Recognition, Measurement and development of supportive documentation



Measurement

- Greatest amount of benefit cumulatively >50% likely of being realised on ultimate settlement
 - Identifying potential outcomes and assigning probabilities based on specific facts and circumstances available at the reporting date
 - More factors than just technical
 - ✓ For example, implementation, maintenance of risks and settlement
 - Judgmental area but will need to be applied consistently by the company

FIN 48 - Client Action Plan

Assessment, Recognition, Measurement and development of supportive documentation



Measurement (cont.) -

Example 1

ASSUME:

- A company takes a deduction in a tax return that creates an “as filed” tax benefit of \$100, e.g., interest deduction
- The position is greater than 50% likely of being sustained on technical merit
- The company estimates the following distribution of potential outcomes:

Amount of tax benefit expected to be sustained	% likelihood the tax position will be sustained at this level	Cumulative probability the tax position will be sustained
\$100	30%	30%
\$ 80	10%	40%
\$ 60	15%	55%
\$ 30	25%	80%
\$ 20	20%	100%

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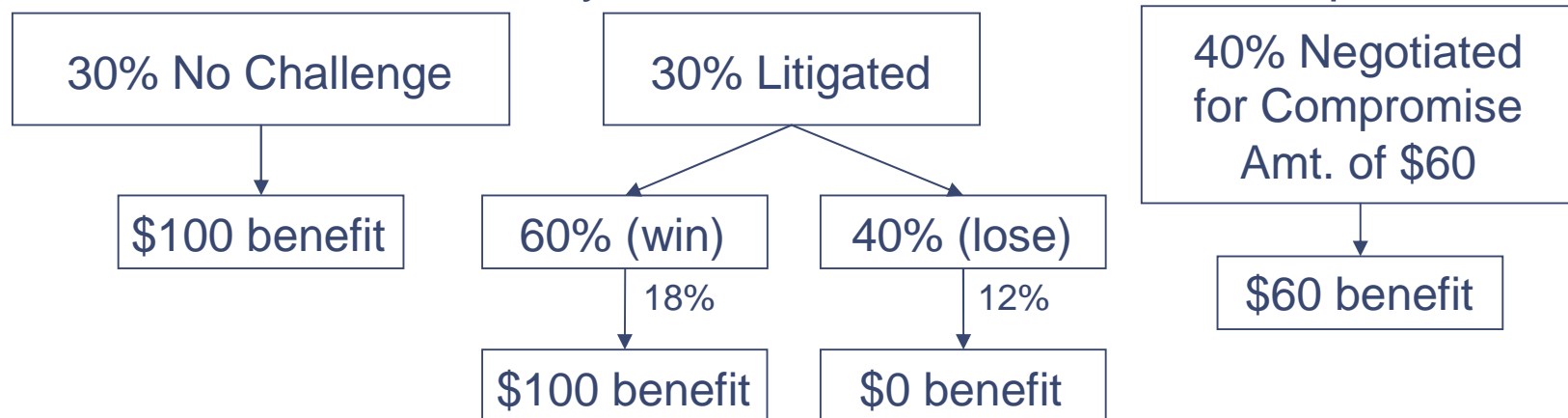
Assessment, Recognition, Measurement and development of supportive documentation



Measurement (cont.) –

Example 2

\$100 Tax Benefit – More likely than not threshold is met in Step 1



Benefit	Individual Probability	Cumulative Probability
\$100	48%	48% (30% + 18%)
\$ 60	40%	88% (48% + 40%)
\$ 0	12%	

FIN 48 - Client Action Plan

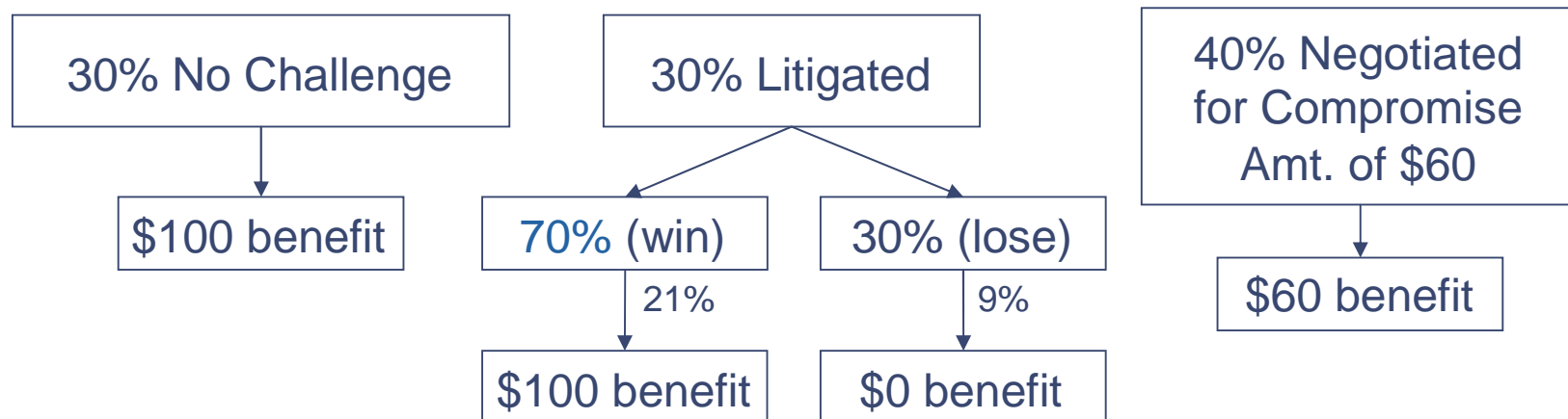
Assessment, Recognition, Measurement and development of supportive documentation



Measurement (cont.) –

Example 3

\$100 Tax Benefit – More likely than not threshold is met in Step 1



Benefit	Individual Probability	Cumulative Probability
\$100	51%	51% (30% + 21%)
\$ 60	40%	
\$ 0	9%	

FIN 48 – Client Action Plan

Assessment, Recognition, Measurement and development of supportive documentation



Documentation

- Development of policies and procedures for information gathering
- Update / crystallization of suitable internal control
- Technical analysis aiming to assess the merit of tax positions
- Find supporting documentation and disclosures



III. Tax Accounting Areas requiring Examination

FIN 48 – Examples for Tax Accounting Areas that require Examination



- Foreign and Local income taxes
- Non-income based taxes
- Tax contingencies
- Tax reconciliations
- Deferred tax balances
- Valuation allowances
- Withholding Taxes
- Permanent Establishment
- Transfer Pricing
- Treaty Positions
- Hedging and Foreign Currency
- IP Migration
- Cross Border Financing
- Specific Jurisdictional Issues
- Tax Holidays
- Cash Repatriation
- M&A



IV. Subsidiaries - Main Challenges

FIN 48 – Subsidiaries - Main challenges

Developing the approach



- Knowledge of tax issues exists closest to the operations but knowledge of FIN 48 exists closest to the HQ
- How to proceed with your marching orders to complete the workbook?
- Can you articulate company policy on reserve approach including penalties
- Where do the reserves exist (at HQ or locally?)
- How do I make judgements? Who should be involved?
- Is this a search for new items or a refinement of known exposures?
- Can I separate non-income tax issues from income tax issues?
- Mature jurisdictions vs. emerging jurisdictions
- Interaction with other stakeholders (financial reporting, business unit controllers)

FIN 48 – Subsidiaries - Main challenges

Substantial points for consideration



- **Data gathering**
- **Joint ventures**
- **Business transformation projects - how effectively implemented?**
- **Existing experience**
- **Role of preparer**
- **Technical opinions/DD reports**
- **Statutory reporting vs. management accounts (legal entity vs. business units)**
- **Are UTPs few but large or all over the place**
- **What is in scope / materiality, prioritization**
- **Permanent items, temporary items**
- **Changes in judgement; changes in tax laws**



V. Questions and Answers

FIN 48 – Questions and Answers

Scope



Does FIN 48 apply to S corporations, real estate investment trusts, regulated investment companies, not-for-profits and governmental entities subject to income taxes (e.g., unrelated business income tax)?

FIN 48 is applicable to all positions accounted for under FAS 109, regardless of the nature of the entity. For example, if the tax positions or the unrelated business income taxes of a not-for-profit or governmental entity are accounted for pursuant to FAS 109, then FIN 48 would be applicable.

FIN 48 – Questions and Answers

Scope



Is a company's decision not to file a tax return in a jurisdiction where it might have nexus or a permanent establishment considered a "tax position"; and how is this accounted for under FIN 48? Also, if a company has not been audited, does it still accrue the related taxes? Wouldn't the liability continue to grow on the books?

FIN 48 states that the decision not to file a tax return is a "tax position"; such a decision may be in respect to nexus in a permanent establishment in a foreign tax jurisdiction. If the company is unable to support the technical sustainability of its position at the prescribed threshold level, it must recognize a FIN 48 liability for the realized but unrecognizable tax benefit, including interest and, potentially, penalties. If the company is able to support the technical sustainability of its position, it will need to measure the benefit as the largest amount that is greater than 50 percent likely of being ultimately realized. Assuming the so determined amount of sustainable benefit is less than the full benefit of not filing returns, the difference would be reflected in a FIN 48 liability.

Additionally, failing to file in a particular jurisdiction would prevent the statute of limitations from commencing; thus, the FIN 48 liabilities possibly never would reverse, and interest would accrue in perpetuity. If the jurisdiction in question has a well-understood practice of pursuing back-taxes for only a clearly defined number of years when asserting nexus, companies would be able to apply the "administrative practice" accommodation and accrue taxes and interest for the defined number of years on a rolling basis.

FIN 48 – Questions and Answers

Scope



Does FIN 48 apply to income tax liabilities that were assumed as part of a business combination or spin-off where the seller or former parent has agreed to fully indemnify the entity that assumed the income tax liability?

Yes. We believe that because the entity that assumed the income tax liability as part of a business combination or spin-off becomes the legal obligor to the taxing authority, that entity must apply the accounting and disclosure requirements of FIN 48 with respect to the assumed income tax positions. For purposes of determining the accounting treatment for any potential recoveries associated with the indemnification, an entity should consider the relevant literature for their specific fact pattern (e.g., FAS 141, *Business Combinations*).

Conversely, the entity that provides the indemnity or similar commercial or contractual tax reimbursement commitment would not assess such obligations under FIN 48 if it is not directly liable to the government for such taxes. Those entities should consider the relevant literature for their specific fact patterns (e.g., FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of indebtedness of Others*).

Depending on an entity's facts and circumstances, we believe this could be a change from past practice. Due to the interaction with other applicable literature that may be necessary to account for possible recoveries under indemnification arrangements and the potential for counterintuitive outcomes, there could be a need for additional guidance in this area.

FIN 48 – Questions and Answers

Scope



Under FIN 48, a company's decision not to file a tax return in a foreign tax jurisdiction where it might have a permanent establishment is considered a "tax position." However, if the company has not been audited by the tax authority, should it still accrue the related taxes? If so, wouldn't the liability continue to grow on the books?

If the company is unable to support the technical sustainability of its position at the prescribed threshold level, it must recognize a FIN 48 liability for the realized but unrecognizable tax benefit — including interest and, potentially, penalties, notwithstanding the fact that it has not been audited by the tax authority. If the company is able to support the technical sustainability of its position, it will need to measure the benefit as the largest amount that is cumulatively greater than 50 percent likely of being ultimately realized. To the extent that the amount measured is less than the full benefit of not filing returns, the difference would be reflected as a FIN 48 liability.

In jurisdictions where failing to file a tax return prevents the statute of limitations from commencing, it is possible that the FIN 48 liability may never reverse, while interest and penalties would accrue in perpetuity. This would not eliminate the need to recognize a liability under FIN 48. If the jurisdiction in question has a widely understood practice of pursuing back-taxes for a limited number of years when asserting nexus, companies would apply the "administrative practices" accommodation described in FIN 48 (paragraph 7(b)) and accrue taxes and interest for those years, along with penalties, if applicable.

FIN 48 – Questions and Answers

Scope



Is it reasonable to expect that almost all companies will have uncertain tax positions?

Yes. Due to the complexities of many tax systems and today's business environment, we believe that almost all companies will at least have some uncertain tax positions in open tax years. Such uncertain positions may also include issues that did not affect the income statement, such as temporary or timing differences, issues that relate to business combinations, share-based payment related issues, or positions that relate to a net operating loss (NOL) carryforward for which there is a full valuation allowance under FAS 109.

FIN 48 – Questions and Answers

Scope



Does FIN 48 apply to income tax liabilities that were assumed as part of a business combination or spin-off where the seller or former parent has agreed to fully indemnify the entity that assumed the income tax liability?

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Conversely, the entity that provides the indemnity or similar commercial or contractual tax reimbursement commitment would not assess such obligations under FIN 48 if it is not directly liable to the government for such taxes. Those entities should consider the relevant literature for their specific fact patterns (e.g., FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of indebtedness of Others).

FIN 48 – Questions and Answers

Scope



Depending on an entity's facts and circumstances, we believe this could be a change from past practice. Due to the interaction with other applicable literature that may be necessary to account for possible recoveries under indemnification arrangements and the potential for counterintuitive outcomes, there could be a need for additional guidance in this area.

FIN 48 – Questions and Answers

Unit of Account



A unit of account is relevant for both the recognition and measurement steps. Should the unit of account be the same for both?

Yes. Though not directly stated in FIN 48, we believe the unit of account should be the same for both recognition and measurement. The unit of account also should be consistently applied from period to period unless, when appropriate, management revises (based on new information) its judgment regarding the selection of the unit of account and concludes that a different unit of account is more appropriate. Factors that might lead to management changing its assessment of the appropriate unit of account include, but are not limited to, changes in organizational structure and level of activity, changes in product line or service offering, and experience with the taxing authority. These types of changes would be characterized as a change in estimate.

FIN 48 – Questions and Answers

Unit of Account



If an enterprise has multiple transactions or positions that are similar and likely to be evaluated by the relevant taxing authority in the aggregate, can the unit of account be the combined transactions (e.g., the unit of account is 50 similar transactions)?

Yes. In certain cases, management's assessment might support one unit of account for all of the transactions (i.e., multiple transactions analyzed as one). Accepting a single unit of account is possible if management's judgment leads to the conclusion that the transactions are substantially the same in terms of the 1) expected tax benefits, 2) relevant technical issues and uncertainties, and 3) taxing authority approach to be taken during an examination (i.e., a portfolio approach). In addition, a taxing authority, while evaluating the tax positions under a portfolio approach, may reject certain positions as a means of settlement because they are precluded from negotiating a settlement on an individual position. In this circumstance, so long as the related positions are substantially the same as noted above, the unit of account would be the combined transactions and measurement would consider the settlement of the positions under a portfolio approach. Accordingly, measurement would be on an aggregated basis, even though the expected taxing authority approach may involve disparate resolutions of individual positions in order to achieve an aggregated outcome consistent with the taxing authority's discretion.

FIN 48 – Questions and Answers

Unit of Account



If an enterprise has taken positions with respect to multiple transactions that require a separate unit of account for each transaction and if all of the positions meet the requirements for recognition, but the taxing authority’s settlement approach is expected to aggregate the positions (i.e., a portfolio approach), would it be possible to have a single, combined unit of account for measurement even though separate units of account were used in the recognition assessment?

We believe the unit of account should be the same for recognition and measurement of a tax position. When the appropriate unit of account is determined to be the individual transaction, the individual transaction is identified as a tax position for FIN 48 purposes and the recognition and measurement steps should be applied to that discrete position. A taxing authority’s portfolio approach to settlement can be viewed as another possible outcome in a range of possible outcomes to be used in the measurement analysis of the greatest amount of tax benefit that is more likely than not to be sustainable for each individual transaction.

For example, assume a research credit has five individual tax positions that all meet the recognition threshold and are expected to be settled using a portfolio approach. In this circumstance, the taxpayer expects to receive 80 cents on the dollar for those five positions in the aggregate. Under this approach each individual position would be recognized at the 80% threshold (i.e., each position is expected to be settled under a portfolio approach). This can be acceptable when there is evidence to suggest that the relevant taxing authority has accepted such a settlement approach in the past.

FIN 48 – Questions and Answers

Recognition



When evaluating whether a tax position has met the recognition criteria, can the effect of another related tax position be considered?

FIN 48 requires that each tax position be evaluated on its own information, facts, technical merits, etc., without consideration of the possibility of offset or aggregation of other positions. For instance, a corporation must separately assess for recognition each known uncertain tax position, even if the corporation expects that it would prevail on one position because it expects to settle another related tax position. Furthermore, the fact that a FIN 48 liability recorded for one position may result in a tax benefit being recognized on another position should not affect the need to separately assess the recognition of a FIN 48 liability on the first mentioned tax position. For example, an uncertain tax position taken in a foreign jurisdiction must be separately assessed for recognition of a FIN 48 liability even though the resulting FIN 48 liability would give rise to a foreign tax credit (FTC) benefit in the parent jurisdiction.

FIN 48 – Questions and Answers

Measurement



Is there any guidance on how to calculate the individual probability percentages?

There is no prescribed method for determining the individual probability of each possible outcome. By necessity, such assessments will require significant judgment by management. Probabilities can be based on factors such as (1) the perceived weight of the tax law in the taxpayer's favor, (2) the extent of precedent of the tax law being applied to the particular position or transaction, (3) expectations regarding how aggressively the taxing authority might pursue a particular position or, alternatively, its willingness to reach a negotiated compromise, and (4) the entity's willingness to defend the position in tax court as opposed to conceding to a negotiated compromise to avoid the hazards of litigation. In the latter case, comparable and resolved exposures that the company or similar companies have experienced will often be relevant in developing measurement estimates and assigning individual probabilities. In this regard, it is expected that a history of negotiating and settling the same or similar tax positions would provide strong evidence in support of individual probabilities.

Importantly, while all potential outcomes should be considered in arriving at possible measurement outcomes and their individual probabilities (e.g., litigation, negotiated compromise, etc.), in accordance with FIN 48, detection risk cannot be considered. That is, the step 2 assessment needs to be done assuming that the taxing authority has full knowledge of the uncertain tax position.

FIN 48 – Questions and Answers

Measurement



It is important to note that a virtually identical tax position could be measured differently by two different preparers based solely on management's appetite for risk and willingness to compromise. For example, a company might determine that if it is challenged, it would litigate the tax position until it is ultimately sustained and the individual probability of sustaining the full amount of the benefit is greater than 50 percent likely. In that fact pattern, the company would record the full amount of the benefit. However, another company might believe that upon challenge, it would be willing to settle for 80 percent of the tax benefit. That company would record 80 percent of the benefit for that tax position (assuming expectation of settlement for that amount is greater than 50 percent likely).

FIN 48 – Questions and Answers

Measurement



The taxing authorities sometimes are not willing (or in certain cases legally permitted) to accept any compromise on a position. Therefore, only two outcomes for an uncertain tax position are possible: 100 percent of the benefit and zero. Under this scenario is it appropriate to conclude that 100 percent of the amount should be recognized as a benefit if the more likely than not recognition threshold has been met?

Yes. Some positions are considered to be “binary” - i.e., there are two outcomes: 1) if the position is sustained, the entire “as-filed” tax return amount will be accepted and 2) if the position is lost upon challenge, none of the “as-filed” tax return amount will be accepted. Therefore the expected tax benefit is either sustained or denied in its entirety. When a binary tax position qualifies for recognition, the measurement of the largest amount of tax benefit would generally result in 100 percent of the expected benefit (i.e., the “as-filed” amount) being recorded.

FIN 48 – Questions and Answers

Measurement



Can past audit results be considered in measuring the likely amount of tax benefit that can be recorded for an uncertain tax position?

Yes. When past audit results are the consequences of a taxpayer and a taxing authority negotiation and settlement, FIN 48 is clear that, for measurement purposes, a taxpayer's recent settlement of a same or similar position is a reliable indication of the expected tax benefit that will be sustained on an audit of the same or similar tax position, all else being the same – i.e., no new information arises since the audit to suggest that the negotiated outcome is no longer acceptable (refer to Appendix A, paragraph A25 of FIN 48). A taxpayer's history of negotiating and settling with a taxing authority on the same or similar tax positions is only one source from which expected outcomes may be derived. It should be noted that a taxpayer's unique experience and resolution of a tax position with a taxing authority generally cannot be viewed as an acceptable administrative practice and precedent for purposes of meeting the recognition threshold in FIN 48, unless such treatment is "widely understood" by other taxpayers (e.g., taxpayers in the same industry). This should not be confused with being able to consider past experience as a source from which possible outcomes may be derived for measurement (assuming a particular position satisfies the recognition threshold).

FIN 48 – Questions and Answers

Measurement



How should a company measure an expected tax benefit from an uncertain tax position for which the company has a "should" level tax opinion?

The recognition and measurement of a tax position are two separate steps in the FIN 48 accounting model. A tax opinion issued by outside counsel or other tax service provider can constitute external evidence supporting management's assertions in relation to the recognition of a tax position. When a tax opinion (with no significant caveats) concludes that a tax position "should" be sustained, that would seem to bolster meeting the recognition threshold in FIN 48, but may not be in-and-of-itself sufficient to justify recording 100 percent of the expected tax benefit, especially when the opinion may only or primarily deal with the sustainability of a position without addressing the amount that can be sustained. Furthermore, if a company knows or has reason to know that the relevant taxing authority expects some concession and the company does not intend to litigate, it would suggest that less than 100 percent of the expected tax benefit might be the largest amount of benefit that has a cumulative probability greater than 50 percent, notwithstanding the existence of a "should" level opinion.



VI. PWC Tel-Aviv FIN 48 Tax Team – Main Contacts

FIN 48 - PWC Tel-Aviv FIN 48 Tax Team – Main Contacts



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