TAX MANAGEMENT

MEMORANDUM

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FIN 48 for Tax Lawyers — Accounting for Uncertainty in Income Taxes

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INTRODUCTION

Accounting terminology has been steadily creeping into the world of tax law. New accounting rules have culminated in Financial Interpretation No. 48 (FIN 48), which makes sweeping changes in the way companies report their income tax liabilities for financial purposes.

Although most tax lawyers are now familiar with FIN 48's new more-likely-than-not reporting threshold, few understand what FIN 48 really means in practical terms. The purpose of this article is to provide a basic background to help lawyers understand what companies are going through and how lawyers can help companies with FIN 48 related issues.

This article is organized into four sections:

- Overview of FIN 48: What does FIN 48 require for tax accruals?
- Down to business: How will FIN 48 affect the next IRS audit?
- Outside counsel questions: How is FIN 48 relevant for your tax practice?
- A step back: Some basic topics for readers less familiar with financial accounting.

OVERVIEW OF FIN 48

What Led to FIN 48?

Prior to FIN 48, the financial statement rules for estimating taxes were subject to varied interpretation. In 1975 the Financial Accounting Standards Board (FASB) issued FAS 5, which applied to all types of contingent liabilities, including tax liabilities. In 1992, the FASB provided more detailed income tax rules in FAS 109, but kept the same general standard for when to accrue a tax liability. Under this standard, a company assumed that a tax benefit re-

[1] S.R. Schneider copyright 2007, all rights reserved. The author would like to thank Steven Dixon and Brian Lynn for their helpful comments on earlier drafts of this article.

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ported on its tax return was allowable for GAAP purposes unless it was ''probable'' that the company would lose the benefit later. To account for the potential loss of the tax benefit on audit, the company would create a tax reserve. This guidance left open many important questions with respect to uncertain tax positions, including how the probable standard should be interpreted.

As a result of these vague standards, diverse practices developed, with companies using inconsistent criteria to recognize, derecognize, and measure benefits relating to income taxes. This meant that it was hard (if not impossible) to accurately compare the reported income taxes of one company with those of another.[2] Although not stated in FIN 48, other concerns may have included fears that companies could potentially use the lack of certainty in measuring tax contingencies as a way to smooth earnings.[3] FASB issued FIN 48, as an interpretation of FAS 109, to address these concerns.

FIN 48 Basics

The FASB goals for FIN 48 are uniformity and transparency. To achieve these goals FIN 48 includes more specific standards for when tax contingencies are recorded and how they should be disclosed. The three core areas in FIN 48 are (i) methodology, (ii) timing, and (iii) disclosure requirements.

Methodology

Pre-FIN 48 rules contained a bias *toward* recording all tax benefits reported on the tax return and then paring back those benefits with a liability reserve to account for potential loss of benefit on audit. The liability reserve lumped all tax positions together into a single overall reserve and took into account real world variables such as the possibility that the IRS may simply not look at an issue and whether issues may be traded at the IRS Appeals level.

In contrast, the new FIN 48 methodology may be perceived as having a bias *against* recording tax benefits through a two-part application of the more-likely-than-not threshold. The new rules apply on an issue-by-issue basis, or in FIN 48 parlance, a ''unit of account.''[4] For each issue, the company must satisfy a recognition threshold and a measurement threshold.

The company must first determine whether, as a legal matter, there is a more-likely-than-not chance of success — the so-called ''recognition'' threshold.[5] This test is based only on the law as of the GAAP reporting date,[6] assumes the IRS has full knowledge of the law and the issue, and does not allow consideration of the ''audit lottery'' or issue trading.[7] The only exception is a relatively narrow rule allowing for ''administrative practices and precedents.'' FIN 48 includes an example of a narrow de minimis threshold meeting this exception.[8]

After satisfying the FIN 48 recognition threshold, the company must then pare back the tax benefits even further through a second measurement threshold. This test only allows the company to report the highest amount of tax benefits that are, more-likely-than-not, expected to be realized.[9] In an all-win or all-lose type of issue, this second step may not change the benefits recognized. However, it could be much more relevant for a valuation or a transfer pricing issue.

One of the most significant ramifications of the new FIN 48 methodology is that a company records *zero* tax benefits if it does not reach an overall more-likely-than-not confidence level. Moreover, the company must now accrue interest[10] and possibly penalties.[11] For example, if a company only has substantial authority for a $100 tax position taken on its tax return, the old rules would record the benefit and then add an amount, such as $60, to the general tax reserve. Un-

[2] *See* FIN 48 (heading titled ''Reasons for Issuing this Interpretation'').

[3] For example, a company could pay $100 of taxes, but ''reserve'' an additional $10 for tax contingencies, thus reporting total taxes for GAAP purposes of $110. This reserve could be created in a period where GAAP income was too high. Later, when income was too low, the tax reserve could be reduced and increase net GAAP income. *See* Dhaliwal, Gleason and Mills, ''Last-Chance Earnings Management: Using the Tax Expense to Meet Analysts' Forecasts,'' *Contemporary Accounting Research* Vol. 21, No. 2 (Summer 2004) at 431-59, *available at http://aaahq.org/ata/meetings/midyear-meetings/2005/DhaliwalGleasonMills.pdf*

[4] Paragraph 5, FIN 48.

[5] Paragraph 6, FIN 48.

[6] Paragraph 8, FIN 48. Additional information learned after the reporting date but before the filing date is not taken into account until the next period.

[7] Paragraph 7, FIN 48.

[8] Paragraph 7, FIN 48. Paragraph A.13, FIN 48 (applying the administrative practices exception to IRS allowance of current expensing for de minimis items otherwise required to be capitalized). FIN 48 speaks in terms of ''limited'' administrative practices allowing technical violations of the law and thus this exception may be interpreted narrowly. Paragraph B.35, FIN 48.

[9] For example, if there is a 5% chance of recognizing a $100 benefit, a 25% chance of recognizing an $80 benefit, and a 25% chance of recognizing a $60 benefit, the amount of the GAAP benefit reported is $60 because there was a cumulative more than 50% chance of recognizing $60 or above.

[10] This expense may be recorded as income taxes or interest expense. Paragraph 19, FIN 48.

[11] If the position does not meet the minimum threshold to avoid tax penalties, a GAAP expense shall be booked for penalties in the period that the tax position is taken. Paragraph 16, FIN 48. For more details on interest and penalty accruals see Rogers and Andrews, ''Fin 48 and Interest Accruals — A Discussion With FASB,'' 2007 *Tax Notes Today* 49-44 (Mar. 13, 2007).

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ISSN 0148-8295

der FIN 48, the company loses that net $40 of benefit and must also record interest cost for the time value of money on the $100 tax liability that FIN 48 effectively assumes the company owes.

Timing

Under FAS 109, when a company recognizes GAAP income it also records the expected tax expense on that income, even if the actual tax liability is deferred. For example, if a company sells an asset through an installment sale it may defer the tax liability under §453,[12] but the company still reports the tax expense currently for GAAP purposes. This way the GAAP income and related tax expense are matched for financial reporting purposes. If the actual tax paid to the IRS is deferred, the tax expense is called a deferred tax liability. Although a deferred tax liability still reduces the corresponding financial income currently, it is like paying the tax with an interest-free credit card. The ability to defer paying the tax frees up cash for other purposes.

FIN 48 does not change the initial testing time for a tax accrual. However, it requires that a company reevaluate its initial tax accrual decision each reporting period based on changes in the law or changes such as the conclusion of an audit or a lapse of a statute of limitations.[13] For example, a company may initially have booked a tax benefit, but in a later year a negative court case could bring the level of authority below more-likely-than-not. In this case the company must "de-recognize" the tax benefit in that later period. A similar change occurs when a company initially does not book the benefit of a tax position but, for example, the statute of limitations lapses before the IRS audits the issue.[14] At this point the company will "release reserves" and receive the financial accounting benefit for the tax position.

Disclosure

One of the most significant aspects of FIN 48 is the new detailed disclosure rules required in the annual financial statements. Companies must disclose the following:

- *Tabular reconciliation.* A tabular reconciliation of aggregate beginning and ending unrecognized tax benefits, including a quantitative breakdown of which changes relate to (i) current versus prior periods, (ii) settlements with the government, and (iii) a lapse in a statute of limitations.[15]
- *Effective tax rate*. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.[16] Only permanent tax benefits, such as a reduction in the tax rate or permanent exemption from tax, would affect the effective tax rate. Temporary benefits, such as tax deferral, are recorded as current tax expense and are taken into account in the effective tax rate computation.
- *Penalties and interest*. 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.[17]
- *12-month warning*. This disclosure applies to positions for which it is *reasonably possible* that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date. Reasonably possible is a relatively low threshold defined as when the chance of the future event occurring is more than "remote" but less than "likely."[18] Companies must disclose (i) the nature of the uncertainty, (ii) the nature of the event that could occur in the next 12 months that would cause the change, and (iii) if possible, an estimate of the amount of the change.
- *Open years*. A description of tax years that remain subject to examination by major tax jurisdictions.

Beyond the Basics

Scope

FIN 48 only applies to *income* taxes — the old FAS 5 continues to govern other taxes such as payroll and excises taxes. FIN 48 explicitly applies to not-for-profit entities, passthrough entities, and entities entitled to a dividend paid deduction, such as a REIT or a RIC, that are potentially subject to income taxes.[19] FIN 48 also covers decisions not to file tax returns,

[12] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[13] Paragraph 10, FIN 48.

[14] Paragraph 10(c), FIN 48.

[15] Paragraph 21(a), FIN 48.

[16] Paragraph 21(b), FIN 48.

[17] Paragraph 21(c), FIN 48.

[18] Paragraph 3(b), FAS 5.

[19] Paragraph 1, FIN 48. An exempt organization, for example, could have income tax contingencies related to the unrelated business income tax. Note that FIN 48 refers to entities subject to its

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ISSN 0148-8295

jurisdictional allocations such as transfer pricing, and character of income.[20]

Effective Date

FIN 48 must be applied to fiscal years beginning after December 15, 2006 — rumors of a delayed effective date were recently quashed.[21] For calendar year companies, this is effective beginning with the 2007 year. Although the 2007 annual report is not due until 2008, FIN 48 will be widely applicable for reports due in mid-May 2007 because the interpretation must be reflected in the first quarter 2007 Form 10-Q. Depending on the company, the 10-Qs are due 40 or 45 days after the end of the first quarter.[22]

In the first 10-Q, the beginning retained earnings must be adjusted for the cumulative application of FIN 48 to prior year tax positions that affect the 2007 financials.[23] Thus, if a company booked a tax position benefit in an earlier year that does not meet the new more-likely-than-not threshold, it must adjust the initial retained earnings downward to reflect the application of FIN 48.[24] Conversely, the company would adjust retained earnings upward if the FIN 48 methodology would have resulted in less tax being reported. Making the adjustments to retained earning means that the upward or downward adjustment is never reflected in the entity's net income — which can be a benefit or a burden depending on whether the adjustment is upward or downward.

Thanks to a recent clarification, one major aspect of FIN 48 will not apply until the first full annual report is due in 2008. The tabular reconciliation disclosure of unrecognized tax benefits is deferred.[25] Absent the clarification, companies were concerned that a special SEC rule would have required this annual requirement to also be shown on the first year's quarterly financial reports.

Classification of Unbooked Tax Benefits

Tax benefits reported on the tax return but not meeting the GAAP threshold for reporting are unrecognized tax benefits.[26] A GAAP liability must be recorded for the enterprise's potential future obligation to the taxing authority for a tax position that was not recognized pursuant to FIN 48.[27] It is a current liability to the extent the enterprise anticipates payment within one year.[28] The liability shall not be combined with deferred tax liabilities or assets.[29]

DOWN TO BUSINESS: HOW WILL FIN 48 AFFECT THE NEXT IRS AUDIT?

FIN 48 has significant potential to impact IRS audits — in favor of the IRS. The IRS already has created a FIN 48 training program so that its auditors will be able to understand and take full advantage of the new GAAP transparency requirements. There are several key ways in which the IRS may use FIN 48.

Let the Taxpayer Highlight the Soft Spots

The FIN 48 public financial statements will contain many road markers for the IRS. The true value of the markers will likely depend on the degree of specificity a company includes in its FIN 48 disclosures. Further, for a global company, the usefulness of the data may be minimized if federal, state, and foreign tax contingencies are lumped together. The road markers are discussed below.

Opening Retained Earnings

Companies are required to apply the FIN 48 standards to pre-2007 open positions as an initial adjustment to retained earnings. The IRS is likely to watch this retained earnings adjustment. A large decrease in retained earnings may mean that the company had a large amount of pre-2007 tax positions that did not meet the more-likely-than-not threshold for benefit recognition. The IRS may be interested in why the company determined that its positions failed to meet the recognition threshold.

Tabular Reconciliation Requirement

Companies are required to show the aggregate change in unrecognized tax benefits, including a quantitative breakdown of changes due to settlements with the government or due to a lapse in a statute of limitations. Although this reconciliation will not break

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rules as "enterprises" but for simplicity, this article refers to generic enterprises as simply "companies."

[20] Paragraph 4, FIN 48.

[21] After a recent TEI report, there was wide speculation that the FASB may delay the effective date of FIN 48. TEI letter to FASB, 2006 *Tax Notes Today* 239-41 (Dec. 12, 2006). At a FASB meeting on Jan. 17, 2007, the FASB voted unanimously to maintain the original effective date despite requests for a delay. *See http://www.fasb.org/board_handouts/01-17-07.pdf.*

[22] *See* section A.1. of SEC general instructions for Form 10-Q.

[23] Paragraphs 23 and 24, FIN 48. *See also* paragraph 4, FIN 48 (defining "tax position").

[24] An enterprise must disclose the cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption. Paragraph 24, FIN 48.

[25] *See* Jenifer Minke-Girard, Speech by SEC Staff: Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 13, 2006). *See* the SEC website for details at: *http://www.sec.gov/news/speech/2006/spch121306jmg.htm#foot2*.

[26] Paragraph 17, FIN 48.

[27] Paragraph 17, FIN 48.

[28] Paragraph 17, FIN 48.

[29] Paragraph 17, FIN 48.

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things down by issue, the IRS's interest is likely to be piqued if, after the close of an audit, they see a large release of tax reserves. The IRS may be especially interested in this fact if the statute of limitations for the year has not yet closed — in this case the IRS may even reopen the audit.[30]

Currently there is an open issue as to whether the close of an audit is sufficient to create such a release of earnings if the statute of limitations is still open. The question is whether the close of an audit is really a meaningful event to release tax reserves if the release of the reserves will cause the IRS to reopen the audit and pursue the remaining items before the statute of limitations closes. The current draft FASB proposal states that settlement has effectively occurred, prompting a release of reserves, if the taxing authority has completed all of its required or expected examination procedures, the enterprise does not intend to appeal or litigate any aspect of the tax position, and it is considered highly unlikely that the taxing authority would reexamine the tax position, presuming the taxing authority has full knowledge of all relevant information.[31] Unfortunately even this clarification is a bit confusing about how the full-knowledge presumption affects the settlement determination.

Effective Tax Rate Changes

FIN 48 requires companies to disclose the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. The IRS may dig deeper if they see a significant difference between the reported and potential effective tax rates due to unrecognized permanent tax benefits.

Penalties and Interest

FIN 48 requires a company to accrue interest on return positions that do not meet the more-likely-than-not level.[32] A company also must accrue penalties if the position does not meet the applicable penalty thresholds, such as the "substantial authority" threshold in §6662.[33] FIN 48 also requires specific disclosure of these amounts in the statement of financial position. The IRS is sure to be interested in the potential interest and penalties that they could collect — it is a bit like dangling candy in front of a child.

12-Month Warning

FIN 48 requires that companies provide a 12-month warning in the financial statements if it is "reasonably possible" that unrecognized tax benefits may significantly increase or decrease. Because "reasonably possible" is a relatively low standard, this rule could serve as a warning to the IRS that they only have 12 months to catch a significant issue before the statute of limitations lapses. The usefulness of this disclosure will depend on the level of detail included in the disclosure as the gross number disclosed could relate to a combination of state, federal, and international income taxes. The disclosure has the potential to be relatively specific because FIN 48 requires that the "nature of the uncertainty" and the "nature of the event" that gave rise to the change must be disclosed.[34]

The IRS Can Just Ask

To the extent that the public financials do not give the IRS enough information, they may simply ask for more details.[35] This request could take the form of IDRs asking about specific items in the financials. For example, if the IRS sees a large change in tax reserves, they might ask for a more detailed breakdown of what made up the change. Alternatively, the IRS may take the route of simply beginning every audit with a generic IDR asking about the composition of tax accruals.

If the IRS were more aggressive, they could cut back on their current "policy of restraint" with respect to requesting tax accrual workpapers.[36] In 2002 the IRS broadened the scope of when it would request accrual workpapers for taxpayers involved in listed transactions.[37] Asking for the FIN 48 workpapers would take audits to a new level and arguably would outsource the IRS auditor's work to the company. The

[30] *See generally* Stratton, "IRS Official Clarifies FIN 48 Remarks," 2007 *Tax Notes Today* 29-3 (Feb. 12, 2007) (Bob Adams of the IRS clarified that the IRS might reopen an audit more often than has been the past practice to ask about a FIN 48 disclosure); Stratton, "FIN 48 Leading IRS to Reconsider Restraint Policy for Workpapers," 2007 *Tax Notes Today* 28-3 (Feb. 9, 2007) (discussing the potential for the IRS to re-open audits).

[31] Paragraph 5, Definition of Settlement in FASB Interpretation No. 48, No. FIN 48-a. The presumption that the IRS has full knowledge casts some doubt on how to treat issues that the IRS has not seen or reviewed.

[32] Paragraph 15, FIN 48. The amount of interest expense is computed by applying the applicable statutory rate of interest for underpayments to the difference between the tax position recognized under FIN 48 and the amount reported or expected to be reported on the tax return.

[33] Paragraph 16, FIN 48.

[34] Paragraph 21(d), FIN 48.

[35] The IRS has authority under §7602(a) to exam the books, records, or other data which may be relevant or material to the underlying issue under review. The IRS can also summons witnesses to give testimony, under oath, as may be relevant or material to such inquiry.

[36] The Supreme Court has held that the IRS has general authority to request tax accrual workpapers. *See U.S. v. Arthur Young & Co.,* 465 U.S. 805 (1984)

[37] *See* Announcement 2002-63, 2002-27 I.R.B. 72; I.R.M. §4.10.20.3.2.

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ISSN 0148-8295

IRS recognizes this as a very sensitive issue and has said that they plan to wait and see what information shows up in the new FIN 48 public financials before considering whether they should amend their accrual workpaper policy.[38]

OUTSIDE COUNSEL QUESTIONS

Effect on Tax Opinions

A company now may use an outside tax opinion to both support its position on an income tax return and to support its position on its financial statements. Before FIN 48, tax opinions may have been used indirectly to support financial statements, but the current elevation of tax accruals under FIN 48 puts more pressure on this point. Companies already have begun seeking outside opinions solely for FIN 48 purposes, even if they would not have sought an opinion to support the return position. This could occur, for example, if there is clearly substantial authority for return filing purposes, but it is less clear whether there is a more-likely-than-not level of authority for FIN 48 purposes.

Although FIN 48 opinions may provide a welcome source of billable work, outside counsel should keep a few things in mind if they know their opinion will be used for FIN 48 purposes. First, if the opinion will be provided to the outside GAAP auditors, it is unlikely to be protected by attorney-client privilege. The drafter may wish to make clear that the opinion was never intended to be privileged to minimize the risk of creating a subject-matter waiver. Second, lawyers should be aware that a FIN 48 opinion could give the appearance of a more direct liability for shareholder suits. Third, lawyers should be careful to keep their opinions from making specific conclusions as to the application of accounting rules. For example, an opinion can state that, based on the law, there is a more-likely-than-not chance of success. However, lawyers should avoid risking unauthorized practice of accounting by opining that, under FIN 48, the tax benefit can be accrued.[39]

Effect on ABA FAS 5 Treaty

Outside auditors regularly ask a company's outside counsel for a list of known contingent liabilities based on the FAS 5 standards. Lawyers have been concerned about the negative effects responding to this inquiry may have on the attorney-client privilege. As a compromise, the ABA created a model handbook on how to respond to these letters, often referred to as the ABA treaty.[40] Now, FIN 48 replaces FAS 5 for income tax contingencies. This creates the possibility that the auditor letter to outside counsel may be revised.

In reality, FIN 48 may have very little, if any, effect on the lawyer's response to the auditor's contingent liability request. Since tax contingencies are only a part of the contingencies covered by the FAS 5 letter, FIN 48 would not affect these other contingencies. Further, since FAS 5 responses typically did not include a response on the merits of the underlying tax issues, the FIN 48 change in measurement standards may be of little significance because ''I am not answering that'' is not affected by a change in standards.

Other Opportunities?

The new FIN 48 transparency may cause companies to work more closely with the IRS on the front end. To obtain faster resolution of FIN 48 issues, companies may wish to seek alternative dispute resolution procedures to accelerate resolution such as the Fast Track Settlement program or early referral to IRS Appeals.[41] Outside counsel can help companies obtain private letter rulings, seek advanced transfer pricing agreements, or participate in the new IRS Compliance Assurance Program.[42]

A STEP BACK

This final section takes a step back and covers some basic background topics for readers less familiar with financial accounting.

Who Uses GAAP?

FIN 48 applies to public or private companies using GAAP. GAAP is the U.S. standard for accounting rules and all U.S. public companies must keep financial books according to GAAP. Foreign companies that are registered on a U.S. securities exchange are also required to keep GAAP books. Many private companies also use GAAP for a variety of reasons.

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[38] *See* Jaworski and Kenney, ''IRS, PCAOB Officials Discuss Tax Accrual Workpapers,'' FIN 48, 2007 *Tax Notes Today* 48-6 (Mar. 12, 2007).

[39] *See, e.g.,* New Legislation Gets Tough On Unauthorized Practice (discussing Michigan penalties for unauthorized practice of accounting); *available at http://leadersedge.michcpa.org/marapr06/ts-unlicensedprac.asp.*

[40] *See* ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, 1976, 1998, 2003.

[41] See IRS Publication 4539 for details about the Fast Track Settlement program and Early Referral to Appeals.

[42] The IRS also created a new program just to resolve FIN 48 issues. *See* ''Expedited Resolution of Uncertain Tax Positions — LMSB Initiative to Address Certain Implications of FIN 48,'' 2006 *Tax Notes Today* 201-17 (Oct. 17, 2006).

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ISSN 0148-8295

Some companies use GAAP because some banks require GAAP financial statements before lending money to the company. Other companies use GAAP because they plan public debt or equity offerings and are trying to build up a history of GAAP financial statements for future investors or lenders.[43]

Who Writes GAAP and Who Doesn't?

The Financial Accounting Standards Board (FASB) is the non-governmental entity that writes GAAP.[44] The FASB is completely separate from the American Institute of Certified Public Accountants (AICPA), which is a professional association comparable to the American Bar Association. The Sarbanes-Oxley Act of 2002 (SOX)[45] created the Public Company Accounting Oversight Board (PCAOB) in 2002 to help avoid Enron-type disasters and to oversee the audit process for public companies that are subject to the securities laws.[46] The PCAOB is a non-governmental independent agency whose duties include establishing auditing standards and procedures. The PCAOB does not have responsibility over GAAP or FIN 48.

How Is Tax Reflected in Financial Statements?

Public companies publish both annual 10-Ks and quarterly 10-Qs.[47] They also are required to file ''current reports'' on Form 8-K to reflect certain significant items as they occur. A company may describe more significant tax items in the Management's Discussion and Analysis section of the Form 10-K, or it may issue a Form 8-K for a more timely announcement of a major tax event.[48]

Most of the taxes are reflected in the actual financial statements such as the statement of cash flows, income statement and balance sheet. Taxes are primarily reflected in the income statement, although they also are indirectly reflected in the other financial reports to the extent that they affect cash flow or balance sheet liabilities. Taxes are most prominent in the specific line item for taxes in the income statement and the related footnotes. These line items may include information such as (i) a reconciliation of the effective tax rate to the federal statutory rate, (ii) a breakdown of significant deferred tax assets and liabilities, and (iii) a list of tax reserves.

FAS 109 — Basic Concepts

In 1992, the FASB issued FAS 109 specifically to govern the accounting for income taxes. FAS 109 created a system to separate current and future year tax items. FAS 109 required companies to: (i) recognize a current liability or asset for current year estimated taxes; (ii) recognize a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards; (iii) measure current and deferred tax assets and liabilities based on existing tax law without accounting for potential changes in the law; and (iv) reduce deferred tax assets by the amount of any tax benefits that, based on available evidence, the company does not expect to realize. To implement these principles, FAS 109 created the following concepts that are still relevant in a FIN 48 world.

Temporary or Permanent Differences

A temporary difference is one that is merely a timing benefit between paying taxes on the item in the current year versus a future year, even if the future year is 20 years later. For example, a temporary difference between the timing of a gain for GAAP and tax occurs if an asset is sold on the installment method. In contrast, a permanent difference is one that

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[43] Another alternative for some private companies is the International Financial Reporting Standards (IFRS). These standards are written by the International Accounting Standards Board (IASB) and may be used more commonly by U.S. private companies doing business internationally. For more information on the IASB see their web site at *http://www.iasb.org/Home.htm.*

[44] For more information about FASB, see their web site at *http://www.fasb.org.* For a comprehensive overview of GAAP and tax principles, see Knott and Rosenfeld, ''Book and Tax: A Selective Exploration of Two Parallel Universes,'' 2003 *Tax Notes Today* 97-29 (May 9, 2003).

[45] Sarbanes-Oxley Act (SOX) of 2002, P.L. 107-204. For more information on SOX see *http://www.sarbanes-oxley-101.com.* One of the most significant requirements of the SOX legislation is §404 of the Sarbanes-Oxley Act of 2002. ''404'' requires specific financial certifications and disclosures on internal controls, requiring management responsibility and an assessment of the effectiveness of the control structure. These controls also apply to audit documentation for taxes and tax contingencies. Remarks of Jane Poulin, associate chief accountant, SEC, *Remarks Before the 2004 AICPA National Conference on SEC and PCAOB Developments*, Washington, D.C. (Dec. 6, 2004). For a copy of a summary of the Poulin speech see *http://www.sec.gov/news/speech/spch120604jdp.htm.*

[46] *See* §101, SOX.

[47] Forms 10-K and 10-Q are both issued pursuant to §13 or §15(d) Securities Exchange Act of 1934 (the ''’34 Act'').

[48] Current reports are filed on Form 8-K pursuant to the same provisions of the ’34 Act that requires the Forms 10-K and 10-Q. For example, in a recent current report for the Ingersoll Rand Company Ltd., the company said that it would add approximately $27 million to a previously determined GAAP tax reserve relating to an IRS dispute. The matter related to an issue involving $217 million in tax, penalty, and interest. The company included the information on the Form 8-K as a result of receiving proposed adjustments from the IRS disallowing certain capital losses. *See* Harris, ''Ingersoll Rand to Increase Reserves by Close to $30M for Disallowed Losses,'' 2006 *Tax Notes Today* 200-2 (Oct. 17, 2006).

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ISSN 0148-8295

will never reverse, such as municipal bond income that creates GAAP income but is not subject to federal income taxes.

Deferred Tax Assets or Liabilities

Temporary differences give rise to deferred tax assets or liabilities. A deferred tax asset is a beneficial tax attribute that can be used in the future, such as an NOL where the loss is recognized for GAAP purposes but carried forward for tax purposes. A deferred tax liability is the inverse — an expected future tax cost associated with a current-year GAAP income item. A deferred tax liability can arise from a sale on the installment method where the GAAP income occurs in the year of sale but some or all of the taxable income occurs in a future year.

Valuation Allowance

A company must recognize a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized.[49] All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of a deferred tax asset. A deferred tax asset can require a valuation allowance if, for example, an NOL is projected to expire unused. The GAAP rules contemplate that certain "tax strategies" can be taken into account to avoid the impairment of such a deferred tax asset.[50] For example, a strategy to generate taxable income to offset the NOL may avoid the impairment of the deferred tax asset.

[49] Paragraph 17(e), FAS 109. A valuation allowance is the same general concept as a tax reserve, except that it specifically applies to deferred tax assets.

[50] Paragraph 22, FAS 109.

Time-Value-of-Money Benefits for Tax Deferral

FAS 109 does not show a direct income statement benefit for the time value of money for tax deferral. Tax deferral beyond one year merely creates a deferred tax liability. However, the benefit of a longer term deferral may surface through higher cash flows, potential lower borrowing costs, and a lower debt-to-equity ratio.

CONCLUSION

FIN 48 is here to stay and it has changed the landscape. Companies have concentrated on meeting the immediate FIN 48 requirements for the 2007 first quarter reporting, but FIN 48 will have ripple effects each and every reporting period. Companies may seek FIN 48 opinions on the underlying legal merits of a position, assistance with FIN 48 penalty and interest calculations,[51] and assistance with IRS inquiries in a tax audit. In the new world, knowing FIN 48 is essential.

This Article Is Not Accounting Advice

Hopefully this article has helped non-accountants understand a little bit more about the accounting world. This article is not intended to go beyond this goal and the discussions of GAAP principles in this article are not intended and should not be relied upon as accounting advice. A detailed analysis of the company's specific facts and circumstances is generally required to conclude on the appropriateness of the application of GAAP.

[51] *See* Urban and Throndson, "FIN 48: Potential Impact of Interest Computations and Penalties," 2007 *Tax Notes Today* 35-65 (Feb. 21, 2007).

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ISSN 0148-8295