2011

FIN 48: Accounting for Uncertainty in Income Taxes

J. Russell Madray, CPA

www.madray.com

info@madray.com

864-233-0502

...helping businesses, accounting firms, and other organizations

understand and implement

technical accounting and auditing issues.

The Madray Group specializes in providing CPE, technical reviews, inspection services, training, and technical assistance to small- and medium-size accounting firms throughout the U.S.

The Madray Group offers training in a variety of ways that add value by enabling professionals to meet the changing needs of their profession. Bring our seminars to your organization! We have a wide variety of topics to choose from. Or we can create a special program just for you. We have speakers with a wide variety of backgrounds and we may have just what you're looking for.

Contact us:

- 864-233-0502
- info@madray.com
- www.madray.com

Follow Us:

www.twitter.com/madraygroup

About The Author

J. Russell Madray, CPA, CIA, CMA, CFM

Russ Madray is president of The Madray Group, Inc., which helps businesses, accounting firms, and other organizations understand and implement technical accounting and auditing issues. The Madray Group, Inc. specializes in providing technical reviews, inspection services, and technical assistance to small and medium size accounting firms throughout the U.S.

As an author, Mr. Madray is responsible for several of the profession's best-selling books. He also authors many of the AICPA's publications and is a frequent contributor to the *Journal of Accountancy*. In addition, he speaks to hundreds of groups each year on accounting and auditing topics and has made presentations in more than 40 states and several foreign countries.

Mr. Madray has more than 20 years of professional experience, including 15 years in public practice. In 1996, he formed The Madray Group to support and facilitate the range of services offered by CPAs to their clients and to assist CPA firms in meeting the changing needs of their profession.

Mr. Madray earned a B.S. in Accounting from Clemson University in 1986 and a Master of Professional Accountancy from Clemson University in 1988. He is a certified public accountant, a certified internal auditor, a certified management accountant, and a certified financial manager. He is a past member of the AICPA's Accounting and Review Services Committee and a past member of the Board of Directors of the SC Association of CPAs.

Mr. Madray is a native of Greenville, SC and resides there with his wife, Beth, and their two children. He is an avid runner and, between writing and speaking engagements, he finds time to compete in triathlons.

Want to learn more about the topics we're discussing today?

Try a Live Webcast!

Take advantage of these upcoming webcasts, featuring Russ Madray:

Date	Topic
Aug 22	**Independence: Who Has to be Independent? What Does It Mean? When Is It Required?** **NOTE:** ***For this webcast only, use promo code WEB25 and save 25% off the regular price of $95—you pay only $71.***
Sep 2	Madray's Practical A&A Update
Sep 14	Preparing the Statement of Cash Flows
Sep 27	ABCs of Compilation & Review Reports
Sep 28	Contingencies: Accounting & Disclosure Requirements

Plus hundreds of other webcasts available on a variety of subjects and topics!

Register today at **www.GAAPquest.com**

No tests! No exams!

All live CPE (not self-study)!

HOW ABOUT A **FREE** 1-HOUR ON-DEMAND WEBCAST?

Simply go to **www.GAAPquest.com** and click on: **Give me the FREE stuff!**

J. Russell Madray – 864-233-0502
www.madray.com
www.GAAPquest.com

EARN FREE CPE CREDITS...

PILOT TEST OUR ON-DEMAND WEBCASTS

Earn free CPE, and be the first to view programs on cutting edge topics, by pilot testing our on-demand webcasts! The purpose of this pilot test is to determine the average completion time of each on-demand webcast, which is then used to calculate the amount of CPE credit awarded per course.

Pilot testers must be licensed CPAs.

HOW TO PILOT TEST

It's easy: Register at www.GAAPquest.com, and attach your resume or a brief bio. Test as many webcasts as you'd like during the pilot testing period. After each webcast, fill out the Pilot Test Evaluation Form telling us how long it took you to complete the course, and at the end of the pilot testing period, we will send you your Certificates of Completion! CPE credits are based on an average of all pilot testers' times.

WANT MORE INFORMATION?

Just ask us!

FIN 48: ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES

INTRODUCTION

FASB Interpretation (FIN) 48, *Accounting for Uncertainty in Income Taxes*, was issued in July 2006 and was effective for fiscal years beginning after December 15, 2006. FIN 48 is now codified in FASB ASC 740, *Income Taxes*. The guidance from FIN 48 applies to all tax positions accounted for under FASB ASC 740, including tax positions acquired in a business combination. A "tax position" for this purpose includes a current or future reduction in taxable income reported or expected to be reported on a tax return, the decision not to report a transaction in a tax return, and an assertion that a company is not subject to taxation. Because of the way a tax position is defined, the guidance applies to not-for-profit organizations, real estate investment trusts, regulated investment companies, and other entities that are potentially subject to income taxes if conditions specified by the tax law are not met. The recognition and measurement principles also apply to evaluating the potential treatment of tax planning strategies used to support the realizability of deferred tax assets.

The guidance from FIN 48 applies to all tax positions, regardless of their level of uncertainty or the nature of the position. However, the recognition and measurement requirements are likely to have the most impact on positions for which current or future deductions may be disallowed or reduced in a tax examination. The guidance applies to situations where the uncertainty is about the timing of the deduction, the amount of the deduction, or the validity of the deduction. The following tax positions are among those subject to the guidance:

- A deduction taken on the tax return for a current expenditure that the taxing authority may assert should be capitalized and amortized over future periods.
- A decision that certain income is nontaxable under the tax law.
- The determination of the amount of taxable income to report on intercompany transfers between subsidiaries in different tax jurisdictions.
- The calculation of the amount of a research and experimentation credit.
- The determination as to whether a spin-off transaction is taxable or nontaxable.

- The determination as to whether an entity qualifies as a real estate investment trust or regulated investment company.
- The determination as to whether an entity is subject to tax in a particular jurisdiction.

Tax benefits associated with positions that are highly certain and not likely to be questioned by the taxing authorities, such as deductions for ordinary salaries paid to employees, are unlikely to be affected by the guidance.

Application

Applying the guidance from FIN 48 to determine how to recognize tax benefits in the financial statements is a two-step process where recognition (Step 1) and measurement (Step 2) should be evaluated separately.

Step 1: Recognition

The guidance established a "more-likely-than-not" recognition threshold that must be met before a tax benefit can be recognized in the financial statements. For each tax position, an enterprise must make a hypothetical assessment: if a dispute with the taxing authority were taken to the court of last resort, is it more likely than not that the tax position would be sustained as filed? If it is, the recognition threshold is met.

Recognition Threshold Considerations

The guidance does not prescribe the type of evidence required to support meeting the more-likely-than-not threshold, stating that it depends on the individual facts and circumstances. A company's position may be supported, in whole or in part, by unambiguous tax law, prior experience with the taxing authority, and analysis that considers all relevant facts, circumstances, and regulations, including widely understood administrative practices and precedents of the taxing authority.

Tax positions supported by "administrative practices and precedents" are those positions which are accepted by the taxing authorities even though the treatment may not be specified by the tax law or the positions may be considered technical violations of the tax law. In an example from FIN 48, the tax law in a particular jurisdiction may not establish a capitalization threshold below which fixed-asset expenditures may be considered deductions in the period of acquisition, but management may be able to conclude based on previous experience that the taxing authority has not historically disallowed current deductions for individual fixed-asset purchases below a specific dollar amount.

The guidance permits such conclusions for what is expected to be a small number of tax positions that reflect widely known and consistently applied practices of the taxing authority. Another example from FIN 48 illustrates how administrative practices may affect evaluations of whether an entity may be subject to tax in a jurisdiction.

In some cases it may be unclear how a tax position should be defined. The unit of account for determining what constitutes an individual tax position is a matter of judgment that should consider the manner in which a company prepares and supports its income tax returns and the approach expected to be taken by the taxing authority during an examination. The determination of the unit of account can significantly affect the amount of tax benefits recognized, particularly if a deduction or other benefit involves multiple issues that vary widely in their degree of uncertainty. For instance, a company may claim a research and experimentation credit for a qualifying research project that contains both expenditures that are highly certain to result in a benefit and expenditures that could be disallowed. If the unit of account is the research project, the company may not be able to conclude that the recognition threshold has been met because some of the benefit associated with the position is likely to be disallowed. Alternatively, if the unit of account is the individual expenditure, management may be able to conclude that the position associated with the highly certain expenditures meets the recognition threshold. Because of this sensitivity, it may be appropriate in some cases to define the unit of account at the lowest level necessary to ensure that significant benefits with widely varying levels of uncertainty are not included in the same unit of account.

Financial Statement Effects

If the tax position does not meet the more-likely-than-not recognition threshold, its tax benefit is not recognized in the financial statements. As a result, financial statement tax expense will be higher than what is reflected in the tax return by the full benefit of the tax position. An enterprise would increase financial statement tax expense by:

- Recognizing a liability for unrecognized tax benefits
- Reducing an income tax refund receivable;
- Reducing a deferred tax asset (e.g., if the as-filed tax position increases a net operating loss carryforward);
- Increasing a deferred tax liability (e.g., if the as-filed tax position increases an asset's tax basis); or
- A combination of any of the above.

Reassessing the Tax Position for Recognition

For each tax position, an enterprise should reassess whether the more-likely-than-not recognition threshold is met at the end of each reporting period. A tax position should also be recognized (a) when the tax matter is ultimately resolved through negotiation or litigation or (b) when the statute of limitations for the relevant taxing authority to examine the tax position has expired.

When a tax position no longer meets the more-likely-than-not threshold, any previously recognized tax benefit is derecognized in its entirety in the financial statements. Using a valuation allowance to derecognize the benefit is not permitted.

Step 2: Measurement of the Tax Benefit

For tax positions that meet the more-likely-than-not recognition threshold, the next step is to determine how much of a tax benefit to recognize in the financial statements. Under the guidance, enterprises should recognize the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with the taxing authority. In this step, the enterprise should also presume that the taxing authority has full knowledge of all relevant information.

In performing the measurement evaluation, an enterprise should consider the amounts and probabilities of the outcomes that could be realized upon ultimate settlement. In many cases this will be a settlement with the relevant taxing authority. An enterprise starts with the largest possible outcome and evaluates whether there is a greater than 50 percent chance it would realize that amount in ultimate settlement. If not, it evaluates the next largest possible outcome. This evaluation continues until the probability of occurrence for an amount is greater than 50 percent. That amount gets recognized in the financial statements as a tax benefit.

According to the guidance, an enterprise has a high degree of confidence in the technical merits of a tax position if it believes that position is based on clear and unambiguous tax law. In this case, the tax position will meet the recognition threshold. In determining the amount to recognize in the financial statements, the enterprise will conclude that there is a greater than 50 percent chance that it will ultimately realize the full tax benefit. Accordingly, it should recognize the full benefit in the financial statements.

Note that the measured amount of the benefit is not a probability-weighted outcome or a single best estimate, which are approaches that are more familiar to accountants. Also, this exercise is highly judgmental and depends heavily on the individual facts and circumstances surrounding each tax position.

Financial Statement Effects

The difference between the financial statement tax benefit and the full benefit is recognized as a higher tax expense in the same way that a tax position that has not met the recognition threshold is recognized. Again, the use of a valuation allowance to reflect the higher tax expense is not permitted.

OBSERVATION: Under Step 1, the evaluation is based on the expected outcome in the court of last resort. Under Step 2, the evaluation is based on the expected outcome in a settlement with the taxing authority.

OBSERVATION: The unrecognized tax benefit liability represents the difference between the tax benefit reported on the tax return for a particular item and the amount of benefit the entity believes it will receive if it is audited and has to settle with the taxing authority. Consider the liability as a contingency "cushion" for the tax adjustment that might be made if audited.

Classification of the Liability for Unrecognized Tax Benefits

Whether to classify the contingent income tax liability as a current or noncurrent liability depends on when the enterprise anticipates paying cash to settle it. If the enterprise anticipates payment of cash to the taxing authority within one year (or within its operating cycle, if longer) the liability should be classified as a current liability — otherwise, it should be classified as a noncurrent liability. In determining the classification of its contingent income tax liability, an enterprise should consider all relevant factors, including the expected timing of an examination, related appeals, and settlement.

Changed Evaluations

With new information, management may change its judgment over how much of a tax benefit it should recognize in the financial statements (e.g., recognition, derecognition, measurement). Depending on when the related tax position was taken — prior fiscal year or interim period in the same fiscal year — changes in judgment are accounted for differently in interim financial statements. Consistent with existing guidance, FIN 48 prescribed the following accounting:

- The effect of a change in judgment over a tax position taken in a prior annual period is recorded entirely in the interim period in which the judgment changes (similar to taxes on an unusual, infrequently occurring, or extraordinary item).
- The effect of a change in judgment over a tax position taken in an interim period in the same fiscal year is partially recognized in the quarter the judgment changes, with the

remainder being recognized over the remaining interim periods (incorporated into the annual estimated effective tax rate).

Interest and Penalties

Interest that the tax law requires to be paid on the underpayment of taxes should be accrued on the difference between the amount claimed or expected to be claimed on the tax return and the tax benefit recognized in the financial statements. The accrual for financial reporting should begin in the period in which accrual would begin under the tax law. An expense must be recognized for the amount of a statutory penalty in the period for which the tax position has been taken or is expected to be taken on the tax return if a tax position does not meet the minimum statutory threshold to avoid the penalty.

The guidance provides choices of where both interest and penalties are classified in the income statement —interest may be classified as income taxes or interest expense, and penalties may be classified as income taxes or another expense, based on an accounting policy election. Enterprises must disclose in the footnotes where interest and penalties are classified.

Disclosure Requirements

FIN 48 introduced significant new annual disclosures in the notes to the financial statements. A significant additional requirement was a table disclosing the beginning and ending balances of unrecognized tax benefits. Companies were also required to disclose the amount of unrecognized tax benefits that, if recognized, would change the effective rate. For example, recognition of an unrecognized tax benefit that corresponds to a recognized deferred tax asset because the deduction was expected to be available for tax purposes at a future date may not change the company’s effective tax rate. FIN 48 also required qualitative and quantitative disclosures related to estimates of unrecognized tax benefits if it is “reasonably possible” the estimate will significantly change in the 12 months after the balance sheet date. This disclosure must include the nature of the uncertainty, the nature of the events that could cause the change, and an estimate of the range of reasonably possible changes or a statement that an estimate of the changes cannot be made. Other provisions of the guidance required companies to disclose the classification of interest and penalties, the amount of interest and penalties included in the income statement each period, and the amount of interest and penalties accrued in the statement of financial position. A description of open tax years by major jurisdiction was also required.

Disclosure Relief for Nonpublic Entities

In September 2009, the FASB issued ASU 2009-06, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*, to address the need for additional implementation guidance on accounting for uncertainty in income taxes. The guidance answers the following questions:

1. Is the income tax paid by the entity attributable to the entity or its owners?
2. What constitutes a tax position for a pass-through entity or a tax-exempt not-for-profit entity?
3. How should accounting for uncertainty in income taxes be applied when a group of related entities comprises both taxable and nontaxable entities?

In addition, after consulting with the Private Company Financial Reporting Committee and others, the FASB decided to eliminate certain disclosures for nonpublic entities. Under the ASU, the disclosure requirements involving uncertainty in income taxes have been reduced for nonpublic entities; they no longer need to disclose a reconciliation of beginning and ending unrecognized tax benefits and possible changes in those amounts that would affect the effective tax rate. As a result, the following disclosures are required for nonpublic entities at the end of each annual reporting period presented:

- 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
- For 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:
    - The nature of the uncertainty
    - The nature of the event that could occur in the next 12 months that would cause the change
    - An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.
- A description of tax years that remain subject to examination by major tax jurisdictions.

The following is an example of these disclosure requirements:

> The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the years ended December 31, 2008, 2007, and 2006, the Company recognized approximately $10,000; $11,000; and $12,000 in

interest and penalties. The Company had approximately $60,000 and $50,000 for the payment of interest and penalties accrued at December 31, 2008, and 2007, respectively.

Included in the balance at December 31, 2008, are $60,000 of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period.

The Company files income tax returns in the U.S. federal jurisdiction, and various states jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, income tax examinations by tax authorities for years before 2004.

OBSERVATION: Although the guidance related to disclosure of open tax years was introduced by FIN 48, the disclosure needs to be included in financial statements even when no uncertain income tax positions are recognized or disclosed.

Disclosure When There Are No Uncertain Income Tax Positions

Although FASB ASC 740 is clear with respect to what types are disclosures are required when uncertain income tax positions exist, many questions have arisen regarding the situation when an entity has evaluated all of their income tax positions and concluded that no uncertain income tax positions exist. Although there is no requirement within FASB ASC 740 (or any other part of U.S. GAAP) to disclose the fact that no uncertain income tax positions exist, many entities prefer to disclose this fact at least in the year of initial adoption of this guidance. The following is an example of this type of disclosure that might be included within the policy notes.

Effective [*beginning of fiscal year, e.g., July 1, 2009*], the Company implemented the new accounting requirements associated with uncertain income tax positions using the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740, *Income Taxes*. That guidance provides that a tax benefit from an uncertain tax position may be recognized when it is more-likely-than-not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, based on the technical merits. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of the guidance and in subsequent periods. This guidance also provides for measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As of [*end of fiscal year, e.g.*

> *June 30, 2010*], the Company had no uncertain income tax positions that qualify for either recognition or disclosure in the financial statements. With few exceptions, the Company is no longer subject to U.S. federal, state, or local income tax examinations by tax authorities for years before 2006.

OBSERVATION: The illustrative disclosure above is optional. If you conclude that the guidance related to uncertain income tax positions will not apply to a particular entity (e.g., an S-Corp with no potential entity-level income tax liability), there is no requirement to state that the guidance does not apply. However, you should document the fact that this issue was considered and the conclusion reached.

The disclosure requirements within FASB ASC 740 may be overlooked by reporting entities that typically are not subject to income tax (e.g., S corporations, LLCs, etc.). Although not specifically required, it may be advisable to address, within the policy notes, circumstances where non-taxable entities have evaluated income tax positions and have concluded that no uncertain income tax positions exist. The following examples illustrate this type of disclosure.

C Corporation Policy Note Disclosure

> Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due plus deferred taxes related primarily to differences between the basis of [*describe the differences*] for financial and income tax reporting. The deferred taxes represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. The Company accounts for investment tax credits using the flow-through method, and thus, they reduce income tax expense in the year the related assets are placed in service or qualified progress payments are made.
>
> Effective [*beginning of fiscal year, e.g., July 1, 2009*], the Company implemented the new accounting requirements associated with uncertain income tax positions using the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740, *Income Taxes*. That guidance provides that a tax benefit from an uncertain tax position may be recognized when it is more-likely-than-not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, based on the technical merits. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of the guidance and in subsequent periods. This guidance also provides for measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As of [*end of fiscal year, e.g.*

June 30, 2010], the Company had no uncertain income tax positions that qualify for either recognition or disclosure in the financial statements. With few exceptions, the Company is no longer subject to U.S. federal, state, or local income tax examinations by tax authorities for years before 2006.

The adoption of the guidance related to uncertain income tax positions did not have a material impact on the Company's financial statements. The Company has concluded that there are no significant uncertain income tax positions requiring disclosure, and there are no material amounts of unrecognized income tax benefits.

LIMITED LIABILITY COMPANY POLICY NOTE DISCLOSURE

The Company is organized as a limited liability company under the South Carolina Limited Liability Company Act and is structured to be treated as a partnership for income tax purposes. Items of income or loss are allocated to the members in accordance with their respective equity interests and are reported on their individual federal and state income tax returns.

Effective [*beginning of fiscal year, e.g., July 1, 2009*], the Company implemented the new accounting requirements associated with uncertain income tax positions using the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740, *Income Taxes*. That guidance provides that a tax benefit from an uncertain tax position may be recognized when it is more-likely-than-not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, based on the technical merits. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of the guidance and in subsequent periods. This guidance also provides for measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As of [*end of fiscal year, e.g. June 30, 2010*], the Company had no uncertain income tax positions that qualify for either recognition or disclosure in the financial statements. With few exceptions, the Company is no longer subject to U.S. federal, state, or local income tax examinations by tax authorities for years before 2006.

OBSERVATION: This disclosure may be modified, as needed, for an S corporation.