FIN 48
Accounting for Uncertainty in Income Taxes

An Interpretation of FASB Statement No. 109

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Today's Agenda

- Overview
- Historical Guidance
- FIN 48 - Overview
- Disclosures
- Illustrative Guidance & Transition
- Q&A

Overview - Reason for Interpretation

- Diverse accounting practices in applying Statement 109
  - Loss contingencies – FAS 5
  - Probable realization – contingent asset approach
  - Combination
    - Routine tax positions – FAS 5
    - Structured transactions – probable realization
  - Other
- Lack of comparability

FAS 5 Historical Guidance

- Accrue “loss contingency” if:
  - It is “probable” that an asset had been impaired or a liability incurred at date of the financial statements, and
  - The amount of the loss can be reasonably estimated

- Disclose if:
  - One or both of the criteria to accrue not met, or exposure to loss exists in excess of the accrual, and
  - There is a “reasonable possibility” that a loss or an additional loss has been incurred

FAS 5 Historical Guidance

- Evaluate likelihood of future events
  - Probable
    - Likely to occur
  - Reasonably possible
    - More than remote but less than probable
  - Remote
    - Slight
- Guidance does not quantify thresholds
- FAS 5 continues to be applicable for the evaluation of non-income tax reserves

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Evolution of the Exposure Draft

- Exposure draft initially adopted a dual recognition / derecognition threshold
  - "Probable" threshold for recognition
  - "More likely than not" threshold for subsequent derecognition
- Disclosures of unrecognized tax benefits added for final Interpretation

Overview – FIN 48

- FASB embraces "Asset Approach" for income tax
- Rejects loss contingency and all other approaches for income tax
- Clarifies and provides greater consistency in criteria for recognition and measurement of tax benefits

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Overview – FIN 48

- Defines “tax position”
- Sustainable position upon examination
- Technical merits of position
- Risk of detection inappropriate
  - Likelihood of audit
  - Likelihood of issue being found
- Asset approach
  - Recognize benefit when “recognition threshold” met
  - Derecognition when “recognition threshold” no longer met
  - Measure the “asset” or benefit where recognition threshold is met

Overview – FIN 48

- Two-step approach
  - Recognition
    - More-likely-than-not threshold
  - Measurement
- Provides criteria for subsequent recognition, derecognition and measurement
  - Changes in judgment
- Provides guidance for
  - Interest and penalties on tax positions not recognized, but benefited on tax returns
  - Classification
  - Disclosure

Scope – What is a Tax Position?

- Tax benefit on return filed or expected to be filed
  - Reduce income tax expense, taxes paid or payable
  - Increase tax benefit and receivable, DTA or refund
- Decision not to file a return
- Allocation or shift of income between jurisdictions
- A characterization of income
- A decision to exclude income, or treatment of a transaction, entity or other position as tax exempt

Step 1 – Initial Recognition of Tax Benefits

- Determine "unit of account"
  - Facts and circumstances in light of all available evidence
  - Consider:
    - Manner in which company prepares and supports tax return
    - Approach the company anticipates the taxing authority will take during an examination
- Initial recognition threshold
  - Will more-likely-than-not position will be sustained upon examination?
    - Based on technical merits of the position
    - Presumption that the tax position will be examined
    - Look to tax law, administrative practices & precedents
    - Evaluate each position individually, on its own merits

"More Likely Than Not" Recognition Threshold

- Greater than 50%
  - Matter of judgment
  - Based on facts and circumstances
  - Consider all available evidence
- A positive assertion that the reporting enterprise believes that it is entitled to the economic benefits of the tax position
- Presumption of examination by taxing authority includes resolution of appeal or litigation process, if any
- Technical merits of a tax position are derived from sources of authority
  - Legislation & statutes
  - Legislative intent
  - Regulations, rulings, case law

Step 2 - Measurement

- For a tax position that meets the more-likely-than-not recognition threshold…
  - Measure initially and subsequently as the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority having full knowledge of all relevant information
  - Consider the amounts and probabilities of the outcomes that could be realized upon ultimate settlement
  - Based on facts, circumstances, and information available at the reporting date

Illustrative Guidance – Measurement with Information about Approach to Settlement

- Scenario
  - The enterprise has determined that a tax position resulting in a benefit of $100 qualifies for recognition and accordingly should be measured
  - The enterprise has considered the amounts and probabilities of the estimated outcomes.

Illustrative Guidance – Measurement with Information about Approach to Settlement

Table of Probabilities & Estimated Outcomes

Possible Estimated Outcome	Individual Probability of Occurring	Cumulative Probability of Occurring
$ 100	5%	5%
$ 80	25%	30%
$ 60	25%	55%
$ 50	20%	75%
$ 40	10%	85%
$ 20	10%	95%
$ 0	5%	100%

Illustrative Guidance – Measurement with Information about Approach to Settlement

- $60 is the largest amount of benefit that is greater than 50% likely of being realized upon settlement

- Actually it's $60 <u>or more</u> that is greater than 50% likely of being realized upon settlement
  - Probability of $60 itself is only 25%

Illustrative Guidance – Measurement with Information about Approach to Settlement

Table of Probabilities & Estimated Outcomes

Possible Estimated Outcome	Individual Probability of Occurring	Cumulative Probability of Occurring
$ 100	25%	25%
$ 75	50%	75%
$ 50	25%	100%

Tax Planning Strategies and Valuation Allowance

- Tax planning strategies

  - Consideration required under FAS 109
  - Discussed in paragraphs 20-22 of FAS 109 in conjunction with future realizability of DTA, and corresponding need for (and size of) valuation allowance
  - If contemplated as source of future taxable income to support realizability of DTA, must meet recognition and measurement criteria of FIN 48

Subsequent **Recognition**, Derecognition, & Measurement

- Subsequent Recognition
  - A tax position which previously did not meet the recognition threshold gets recognized in the first interim period in which:
    - The more-likely-than-not recognition threshold is met by the reporting date, or
    - The tax matter is settled through negotiation or litigation, or
    - The statute of limitations for the tax position has expired
  - A tax matter need not be legally extinguished to subsequently recognize or measure a tax position
  - Based on management's best judgment in view of facts, circumstances, and information available at reporting date

Subsequent Recognition, **Derecognition**, & Measurement (continued)

- Derecognition
  - Derecognize (previously recognized) tax position in the first interim reporting period in which it is no longer more likely than not that the position will be sustained upon examination
  - Valuation allowance is <u>not</u> a substitute for derecognition
  - Based on management's best judgment in view of facts, circumstances, and information available at reporting date

Changes in Judgment

- Changes in judgment resulting in subsequent recognition, derecognition, or change in measurement of tax position taken previously
  - If initial tax position was taken in prior annual period, recognize change as “discrete” item in period of change
  - If initial tax position was taken in prior interim period within same fiscal year, apply APB 28 (Interim Financial Reporting) and FIN 18 (Accounting for Income Taxes in Interim Periods) to take change into account over remaining periods in fiscal year using effective tax rate calculated for interim period
- Based on evaluation of *new information* – not new evaluation, or new interpretation by management, of information that was available in previous period

Interest and Penalties

- Interest
  - FIN 48 requires accrual if position in tax return is not recognized in financial statements under FIN 48
  - When tax law requires interest on underpayment, start recognizing in 1st period it would begin accruing under tax law
  - Amount is statutory interest rate times difference between FIN 48 tax position and amount taken in tax return
- Penalties
  - Recognize when tax position does not meet minimum statutory threshold to avoid payment of penalties
  - Recognize in period in which company claims or expects to claim position in tax return

Classification

- "Unrecognized tax benefit" concept
  - Difference between position in tax return and benefit recognized and measured under FIN 48
    - Creates liability (or reduces amount refundable or DTA, e.g., NOL)
    - Represents company's potential future obligation to taxing authority for tax position taken in tax return but not recognized pursuant to FIN 48 recognition/measurement guidance
- Liability is current or non-current based on expected timing of payment of cash
  - Current if within one year (or operating cycle, if longer)
- Liability recognized is generally not a deferred tax liability
  - DTL only if it arises from a taxable temporary difference
- Interest recognized under FIN 48 –
  - Accounting policy decision to classify as either income taxes or interest expense

Disclosures

- Accounting policy for classification of interest and penalties
- At the end of each annual reporting period:
  - Tabular “rollforward” of unrecognized tax benefits (“UTBs”) at beginning and end of period
  - Total amount of UTBs that, if recognized, would affect the effective tax rate
  - Total amount of interest and penalties recognized in the income statement and balance sheet
  - Description of tax years that remain subject to examination by major jurisdictions
  - Paragraph 21(d) - Positions where it is reasonably possible that the total amounts of UTBs will significantly increase or decrease within 1 year of reporting date
    - Nature of uncertainty
    - Nature of event that would cause the change
    - Estimate of range of change, or statement that “can’t estimate”

Disclosures

- Tabular rollforward includes:
  - Gross amts of increases & decreases in UTBs as a result of tax positions taken during a <u>prior</u> period
  - Gross amts of increases & decreases in UTBs as a result of tax positions taken during the <u>current</u> period
  - Decreases in UTBs relating to <u>settlements</u> with taxing authorities
  - Decreases in UTBs resulting from lapses in <u>statutes of limitations</u>

Illustrative Guidance - Tabular Rollforward

	(*in millions*)
Balance at January 1, 2007	$370,000
Additions based on tax positions related to the current year	10,000
Additions for tax positions of prior years	30,000
Reductions for tax positions of prior years	(60,000)
Settlements	(40,000)
Balance at December 31, 2007	$310,000

Disclosures

- Rollforward/reconciliation "roadmap"?
  - FIN 48 tabular rollforward requires disclosures only at *aggregate* level, not at *individual* tax position level
    - Not by jurisdiction
    - Not tax position by tax position

Disclosures

- Paragraph 21(d)
  - Positions where it is <u>reasonably possible</u> that the total amounts of UTBs will <u>significantly</u> increase or decrease within 12 months of reporting date
    - Disclose the <u>nature</u> of uncertainty (i.e. describe tax position)
    - Disclose the nature of <u>event</u> that would cause the change
    - Estimate of range of change, or statement that “can’t estimate”

Disclosures

- Paragraph 21(d) – (cont.)

- One of the more controversial areas of FIN 48 disclosures
  - Define 'reasonably possible'
    - Includes tax positions that are both recognized as well as not yet recognized (due to 'reasonably possible' range including probabilities above and below MLTN).
  - "Nature of Uncertainty" – how much detail must be disclosed?
    - Boiler-plate will not be acceptable
  - Significant analysis, documentation and judgment
    - All this must be performed and disclosed in the correct reporting period. Close scrutiny will be applied to evaluate the quality of the effort and conclusions arrived at in prior periods. Documentation will be an important source of evidence of past analysis and thought process.

Effective Date and Transition

- Effective for FYs beginning after December 15, 2006
  - e.g., calendar year 2007 companies
  - Early adoption permitted
    (provided company hasn't yet issued interim financials for that FY)
- Apply more-likely-than-not threshold to <u>all</u> income tax positions for <u>all</u> open years
- Recognize cumulative effect of applying FIN 48 as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the balance sheet)
- SAB 74 requires disclosure of impact of FIN 48 on public company financial statements

Illustrative Guidance

- Guidance provided in illustrations
  - Unit of Account and the Two-Step Process
  - Subsequent event
  - Differences related to timing

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Illustrative Guidance – Unit of Account

- Unit of Account and the Two-Step Process
  - Facts: Four R&D Projects (A,B,C,D)
    - Each project is a separate “Unit of account”
  - Recognition: determined at unit of account
    - Projects A, B & C: Meet Recognition Threshold
    - Projects D: Does not meet
  - Measurement: determined at unit of account
    - Projects A, B, C: Record benefit based on ‘best estimate’
    - Projects D: No benefit recorded, even though it is thought that a portion of D’s credit may be sustained
  - Take-away
    - *The recognition determination is made for each unit of account. Unit of account determined based on facts and circumstances of issue in question.*

2 Step Approach

- Valuation versus Validity
  - When an issue?
    - Goodwill versus other intangibles
    - Cross border activities - transfer pricing
    - Contributions
  - Validity (Recognition)
    - Ability to assign FV is based upon clear unambiguous tax law - meets MLTN recognition requirement
  - Valuation (Measurement)
    - FV requires ‘best estimate’ determination
  - Take-away
    - *Even when the recognition threshold is met for valuations, the best estimate must be determined based on supportable data.*

Illustrative Guidance – Subsequent Event

- Reporting Subsequent Events
  - Facts
    - Statutes closed through 2001
    - IRS exam 2002-2004 during 2007
    - Tax position MLTN recognition met – matter in litigation by another company
    - Unfavorable Litigation outcome in Q1 of subsequent year before report issued
  - Evaluation
    - At the reporting period, 12/31/07, management evaluated position and determined MLTN criteria met and position could be upheld
  - Take-away
    - *Subsequent recognition, derecognition and measurement occurs based on facts, circumstances and information available at the reporting date.*

Illustrative Guidance – Timing of Deduction and Associated Deferred Items

- Differences Related to Timing
  - Example Facts
    - Asset purchase identifies newly acquired goodwill, fully deducted in first year on tax return
    - Not amortized for book
  - Recognition
    - Recognition threshold not met, which would have provided for 15 year amortization
  - Measurement
    - Deferred tax liability is based on 'best estimate' (15 yr amortization), and the difference to the 'as filed' amount is shown in non-current tax liability
  - Take-away
    - *An accrual for uncertain tax positions is recorded for the difference between the tax return as filed and a hypothetical tax return based on MLTN positions. Deferred taxes are recorded for differences between the hypothetical tax return and GAAP treatment.*

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Documentation

- AU 9326 Evidential Matter
  - ***.13 "…the auditor's documentation should include sufficient evidential matter about the significant elements of the client's tax exposure analysis..."***
  - Sufficient, competent, evidential matter about assertions in the financials statements of material significance – i.e., documentation and support
- FIN 48
  - Document tax positions – where book and tax treatment differs and for items treated the same as book
  - Make assessments as to whether tax benefits can be recognized and when

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404

- Document processes
- Controls adequate
- COSO assertions met
  - Occurrence
  - Existence
  - Completeness
  - Valuation or Allocation
  - Rights & Obligations
  - Presentation & Disclosure

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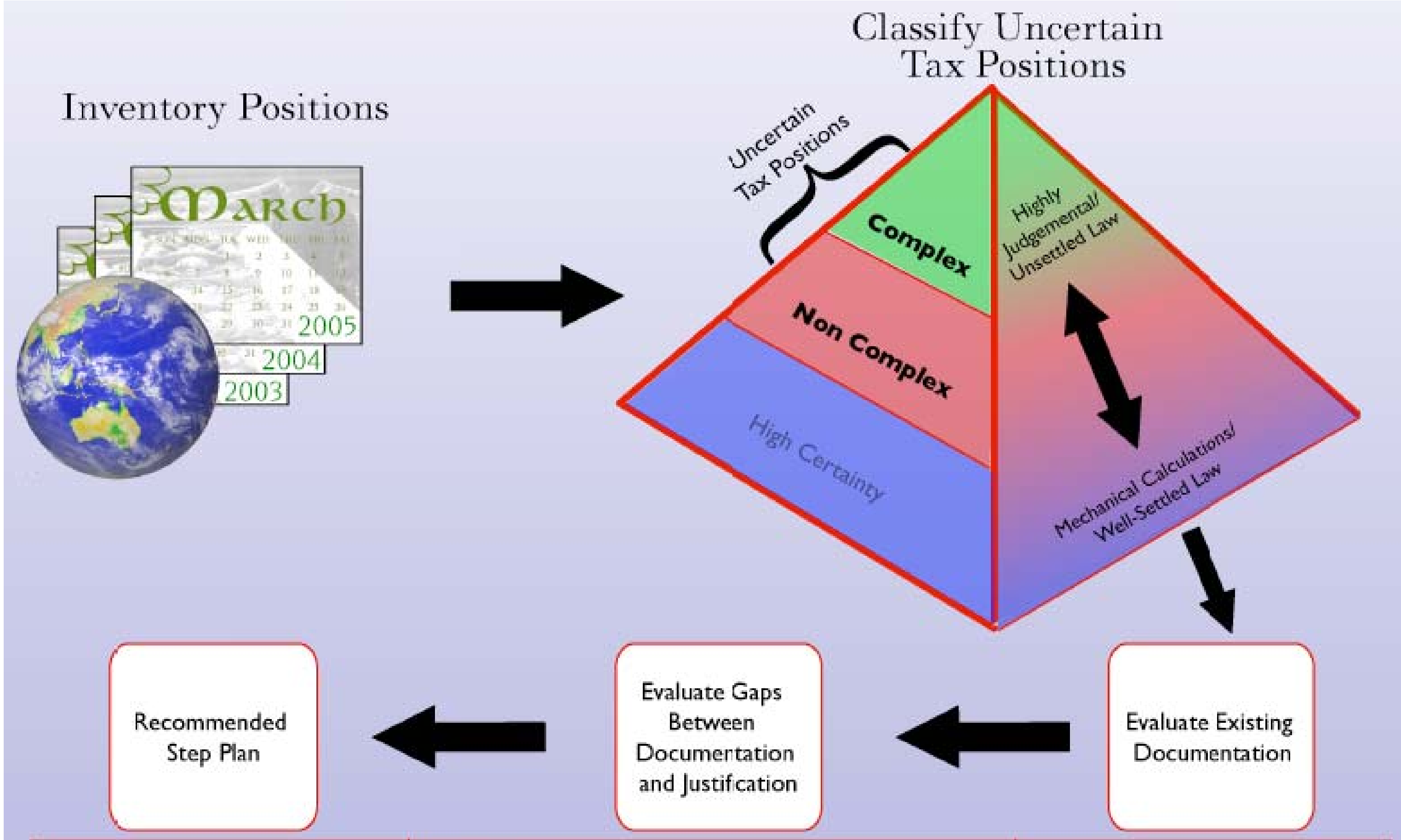
Implementation Objectives

- Inventory tax positions
- Classify
  - Uncertainty
  - Complexity
  - Materiality
- Evaluate existing analysis and documentation
- Address gaps
- Use a controlled process
- Quantify cumulative effect
- Consider impact on controls/404

Workplan Resources

	Team		Management
People	- Trained - Accounting and Tax Resources - Subject Matter Experts	← Knowledge ← Data	- Educated on key issues - Team leader / point person - Communication
Process	- Tailor work program - Support & Document - Technical & law updates - Quantify	Technical Knowledge →	- Controlled objectives - Controlled data - Review procedures - Representations
Technology	- Automated process - Reduced mechanical error risks - Record retention	Data →	- Consistent information - File access
Objectives:	**Controlled Process**		**Approval & 404 Controls**

Assessment



Objective:

*Provide a recommended course of action to close the gap between certainty and justification of tax positions

Process:

*Evaluate company's tax filings and workpaper documentation to identify risk areas
*Inventory and categorize uncertain positions
*Evaluate existing documentation and tax analyses
*Discern the gap between certainty and justification
*Present a recommended step plan

Deliverables:

*Substantiation/documentation gap analysis
*Recommendations for closing the gap.

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Implementation Issues - R&D

- Status of Federal Credit
- Identify Scope
  - All open tax years identified
    - Statutes of limitation differ by state
      - California: four years
    - Carryforwards
      - Carryforwards from years with NOLs
- Identify Appropriate Unit(s) of Account

Implementation Issues - R&D

- Which unit(s) of account will you use to quantify your Company's research credit positions and/or qualified research expenses ("QREs")?
  - Projects
    - IRS considers following units when sampling on exams:
      - In-house & vendor
      - Enhancement & maintenance
      - Commercial & internal use software
  - Cost centers/departments
  - Activities
    - Elements of qualified process of experimentation
    - Tying units of account to statute
  - Job titles
  - Contractors or contracts
  - Other expense types, for example:
    - Above-first-line managers
    - Highly-paid employees
    - Prototypes
    - Patent-related costs

Implementation Issues - R&D

- Recognition – Technical Issues
  - QREs
    - Methodology for identifying
      - IRS *Briefing Paper on Taxpayer Approaches to Capturing Costs for the Research Credit*
      - Reliably excludes all non-qualified costs while including all qualified costs
    - Prototype expenses: depreciable property?
    - Extraordinary utilities: "merely comparing the square footage electricity use in an administrative building with a research facility is insufficient."
    - QREs must relate to qualified research
  - Qualified Research
    - Non-core R&D, e.g., marketing, manufacturing, QA, field engineering
    - Direct supervision: above first-line manager
      - Job titles/org charts are not uniquely dispositive
    - Direct support: e.g., patent expenses, secretary expenses

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Implementation Issues - R&D

- Recognition – Technical Issues (cont.)
  - Calculation
    - All relevant entities included
      - Members of “controlled group of corporations”
        - More than 50% stock ownership, not just 80%+
      - Members of “group under common control”
    - Base amount correctly calculated
      - Fixed base %
      - Start-up or not
    - “Gross receipts” used
      - Expansive definition
    - Acquisitions and dispositions accounted for

Implementation Issues - R&D

- Measurement
  - Documentation
    - Inadequate or poor documentation may cause the amount ultimately to be realized upon exam to be less than the amount permitted to be recognized on the merits of the tax law
    - Leverage existing documentation
      - Create roadmap or bridge between existing company documentation and legal tests
    - Identify and document QREs using statutorily-explicit elements, viz., elements of a qualified process of experimentation
  - Consistency provision
- 404 Controls
  - Identification
  - Documentation
  - Leverage existing accounting and documentation systems

Implementation Issues - International

- Identify scope
  - Jurisdictions
    - Country-by-country
    - Branches
  - Statutes of limitations
    - All open tax years
    - Statutes of limitation differ by country
    - Non-filing with no statutes of limitations
  - Law
    - In each country
    - Treaties
    - Competent authority
- Administrative Guidance

Implementation Issues - International

- Identify issues
  - Transfer Pricing
    - For all countries
    - Group by similar transactions (sale by product line, services, intangibles, etc.)
  - Foreign Tax Credits
    - Eligible tax
    - Expense allocations
    - Overall foreign loss
  - Supply Chain Restructuring
    - Permanent establishment risk of principal
    - Transfer pricing risk
  - Section 367
  - Currency and Exchange Gain and Loss

Implementation Issues - International

- Identify issues (cont.)
  - ETI positions/ IC DISC positions
    - Foreign Economic Processes
    - Qualifying sales
    - U.S. content
  - Intellectual Property Migration
    - Buy-in Payments
    - Cost Sharing Agreements
  - Permanent Establishment
  - Subpart F/Section 956
  - Hybrid Instrument
  - Check-the-box
    - Was it eligible
    - Dual consolidated losses

Implementation Issues - International

- Determine confidence level
  - Impact of competent authority?
- Support
  - What documentation is required?
  - Will existing transfer pricing documentation suffice?
- Quantify amount
  - Taxes in all relevant jurisdictions
  - Currency fluctuation
  - FTC benefit
  - APB 23 issues
  - Penalties and interest
- 404 controls
  - Processes
  - Procedures
  - Systems and controls

Implementation Issues – SALT

- Scope
  - What is the Unit of Account?
    - State by state
    - Nexus
    - Apportionment
    - Issue by issue
  - Jurisdictions
    - State-by-State analysis
    - Focus on the MLTN standard
    - Recognition
    - Measurement
  - Statutes of limitations
    - All open years
    - Non-filing based upon constitutional positions or Public Law 86-272 results in no statute of limitations
  - Law

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Implementation Issues – SALT

- Identify issues
  - State income tax nexus
    - FIN 48 seeks <u>consistent treatment</u> of uncertain income tax positions
    - However, in the SALT environment we lack national and definitive authority for state tax jurisdiction (*Quill*)
    - If a multi-state taxpayer determines it does not have any nexus creating activity in a jurisdiction and does not file a return in the particular jurisdiction, the SOL does not expire.

Implementation Issues - SALT

- Statute of limitations/ nexus
  - The position to not file a return may be reasonable but because of the controversial and unsettled law on nexus, the multi-state taxpayer may be unable to reach the MLTN confidence level for financial statement reporting under FIN 48.
  - Further, the taxpayer may (should, if MLTN not met) accrue penalties and interest on its financial statements.
  - This aggregate liability may never disappear from its financial statements unless the business is audited and the state determines that it does not have nexus.
  - FIN 48 administrative practices and nexus

- State Apportionment
- State Business/Non-business positions

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Implementation Issues - SALT

- State Structures
  - Dis-aggregation of the vertically integrated supply chain (e.g., Purchasing, Distribution, Management, Marketing & Advertising Companies)
    - Unit of account - grouping of products and services
    - Documentation of intercompany transactions – Transfer pricing
    - Lack of documentation undermines economic substance
- Loss Limitation

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Implementation Issues - SALT

- Determine confidence level
  - Multi-state corporate taxpayers who historically used a standard higher than MLTN (e.g., should) cannot flow unrecognized benefits through the P&L account but must book the differences through retained earnings
- Support
  - What documentation is required?
  - Is the existing transfer pricing documentation enough?
- Quantify amount
  - Taxes in all relevant jurisdictions
  - Penalties and interest
- 404 controls
  - Processes
  - Procedures
  - Systems and controls


Q&A
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- Trust
- Independence
- Professionalism
- Client Service

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