

# PKF PERSPECTIVES

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## FIN 48

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As many of you in the business community are already aware, in July 2006 the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. (FIN) 48, effective for fiscal years beginning after December 15, 2006. This new guidance is designed to provide consistent accounting practices and criteria for enterprises reporting tax benefits from **uncertain** tax positions (generally, those claimed on an income tax return, which may or may not be sustained based on audit by a governmental taxing authority).

***FIN 48 applies to all entities (including tax-exempt organizations with respect to exempt income) that prepare financial statements under accounting principles generally accepted in the United States of America (U.S. GAAP).***

### MECHANICS OF FIN 48

Under FIN 48, tax benefits (e.g., deductions, credits) from uncertain tax positions that reduce an enterprise's current or future income tax liability are reported in its financial statements only to the extent each benefit is recognized or, considered more likely than not, to be realizable.

Each benefit is measured by a two-step approach:

- (1) **Recognition:** The enterprise must evaluate each tax position to assess whether, based on the "technical merits" (i.e., based on the relevant tax law authorities), it is "more-likely-than-not" that the position would be sustained upon examination (including related appeals or litigation processes) by a tax authority that has full knowledge of all relevant information. The term "more-likely-than-not" means a likelihood of more than 50%. Tax benefits that do not meet the "more-likely-than-not" standard should not be recognized in the financial statements (i.e., a FIN 48 liability should be recorded on the financial statements).
- (2) **Measurement:** If a tax position satisfies the more-likely-than-not threshold in (1) above, the enterprise can then proceed to measure the amount of tax benefit from the position that can be recognized in the financial statements. Under a "cumulative probability" approach, an enterprise will record in its financial statements the largest amount of tax benefit that is greater than 50% likely of being realized after settlement with a tax authority that has full knowledge of all relevant information.

For example, assume a tax position has the following benefit outcomes for a \$100 tax benefit:

Possible Benefit 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%

Based on the above, the net tax benefit to be recorded would be \$60, the largest amount with a cumulative probability greater than 50 percent. Accordingly, if the entire \$100 benefit has been recorded in the enterprise's financial statements, a benefit reserve of \$40 would be recorded as "FIN 48 Liability" on the balance sheet and "tax expense" on the income statement.

### SUBSEQUENT RECOGNITION AND MEASUREMENT OF TAX BENEFITS UNDER FIN 48

After the initial two-step evaluation of an uncertain tax position, an enterprise must, at each subsequent financial reporting date, review the facts, circumstances and information available at that reporting date to determine if it should reassess the tax position. A new assessment must be based on **new information** rather than a new evaluation or interpretation of information that was available at the earlier reporting date.

If a tax position that previously failed to meet the more-likely-than-not recognition threshold subsequently meets that threshold (i.e., is recognized), the enterprise recognizes a tax benefit in its financial statements in the first interim period in which any of following three conditions is met. Under FIN 48, as originally promulgated in 2006, these conditions were as follows:

- (1) The more-likely-than-not standard is met by the reporting date, or

- (2) The tax matter is ultimately settled through negotiation or litigation (*see below*), or
- (3) The statute of limitations for the relevant taxing authority to examine the tax position has expired.

### **NEW “EFFECTIVELY SETTLED” STANDARD REPLACES “ULTIMATELY SETTLED”**

The FASB staff has amended FIN 48 to provide guidance on how an enterprise determines whether a tax position is effectively settled when determining if previously unrecognized tax benefits may be recognized [FASB Staff Position (FSP) FIN 48-1]. The FSP replaces the “ultimately settled” standard for negotiation or litigation with an “effectively settled” standard.

FSP FIN 48-1 changes the second condition above, to provide that an enterprise may recognize a previously unrecognized tax benefit if the tax position is effectively (as opposed to “ultimately”) settled through examination, negotiation, or litigation. The change was made following a request from FASB's board that the FASB staff clarify that a tax position may be effectively settled after examination by a taxing authority for purposes of FIN 48 ¶10(b). Under FSP FIN 48-1, enterprises are directed to assess whether a position is settled on a position-by-position basis, but they may conclude that all positions for a tax year are effectively settled.

FIN 48 requires an enterprise that had previously treated a position as effectively settled to re-evaluate it under FIN 48 if the enterprise becomes aware that the taxing authority may examine or re-examine the tax position, or may appeal or litigate any aspect of it.

Finally, FIN 48 acknowledges that an enterprise may, during the exam process, obtain information enabling it to change its assessment of the technical merits of similar tax positions taken in other periods. However, the “effectively settled” conditions in FIN 48 may not provide any basis for an enterprise's decision to change its assessment of the technical merits of any tax position in other periods.

### **IMPLICATIONS OF FIN 48**

A recent study of the first quarter 2007 financial statement filings under FIN 48 has shown approximately \$57B in reserves for uncertain tax positions for public companies. If these positions remain unchallenged by the IRS, future reported earnings would increase accordingly.

When the FASB required specific footnote disclosures of an enterprise's FIN 48 analysis, it did not intend to provide the IRS with an additional audit tool. However, IRS Chief Counsel Korb has repeatedly indicated that the IRS would

not turn a “blind eye” to such developments. **Thus, public companies, whose financial statements are publicly available, must be mindful that the IRS may review FIN 48 disclosures for identifying uncertain tax positions.**

### **EXAMPLES OF POTENTIAL TAX EXPOSURE**

**State and Local Taxation:** The filing requirements for a state or local return in many instances is not always clear. The filing of such returns is dependent upon whether a company is doing business in a particular jurisdiction. In many instances, a company might have temporary business in a state and choose not to file a state return. If a return is never filed, the statute of limitations never expires and the exposure never disappears. In other words, once this potential liability is established under FIN 48, it may never be reversed.

**Transfer Pricing:** In the case of transfer pricing matters for multinational enterprises, there can be potential uncertainty in many countries. For example, a U.S. company has operations in a number of countries. In each operating country, the U.S. company has transactional dealings with affiliates located in other countries. Such related-party transactions are the object of the transfer pricing laws and procedures in each country. Under FIN 48, these potential exposures in each country for foreign tax must be evaluated and measured.

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PKF is continuing to study the effects that FIN 48 has on its clients. We are also available to discuss with management the impact this new accounting standard has on a company's financial statements and tax preparation process.

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