

**AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS**

**PRACTICE GUIDE ON
ACCOUNTING FOR UNCERTAIN TAX POSITIONS
UNDER FIN 48**



November 29, 2006

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Description and Scope of Practice Guide

[Financial Accounting Standards Board Interpretation \(FIN\) No. 48, Accounting for Uncertainty in Income Taxes](#), was issued in July 2006 and interprets FASB Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. Implementing FIN 48 raises important issues for financial-statement preparers, auditors, and tax advisers.

Generally, companies seek to legitimately reduce their overall tax burden and minimize or delay cash outflows for taxes. Positions taken in tax returns may be well-grounded and taken in good faith, but with the complexities and varying interpretations of the tax law, these may not ultimately prevail. FIN 48 establishes the accounting for uncertain tax positions, including recognition and measurement of their financial statement effects.

This practice guide presents a summary of FIN 48, as well as related accounting, auditing, and tax issues. The guide was developed by the members of the AICPA's Tax, Accounting Standards, and Audit and Attest Teams, with particular thanks to Fred Gill, Charles Landes, Daniel Noll, Judith Sherinsky, William Stromsem, and George White, along with member experts in their divisions with whom they consulted.

This document is for educational purposes and is not intended to provide tax or other advice that should be relied on without independent review and analysis of FIN 48 and its implications by CPAs.

Highlights of FIN 48

Scope

Before FIN 48, accounting for uncertain tax positions was governed by SFAS No. 5, *Accounting for Contingencies*. FIN 48 replaces SFAS No. 5 with respect to the accounting for all tax positions, not just uncertain tax positions. FIN 48 applies to all entities that prepare GAAP financial statements. For example, even tax exempt entities that prepare GAAP financial statements must consider whether exempt income might be determined to be unrelated business income, and whether the entity has properly maintained its exempt status.

The accounting for all material positions taken (or expected to be taken) on any income tax return is governed by FIN 48. Income tax returns include those that were filed or that should have been filed with local, state, federal, and international taxing authorities. FIN 48 applies to positions such as: (1) excluding income streams that might be deemed taxable by the taxing authorities; (2) asserting that a particular equity restructuring is tax-free when that position might be uncertain; or (3) the decision not to file a tax return in a particular jurisdiction for which such a return might be required.

FIN 48 also significantly changes the treatment of positions that have only timing consequences, such as positions involving depreciation. Although these positions generally do not affect the

aggregate amount of taxes payable over time, they generate an economic benefit by delaying the payment of taxes. Historically, companies may have accrued a liability for only the interest and possibly penalties related to such positions, but did not further analyze the position's sustainability because disallowance would merely result in converting a deferred tax liability to a current tax liability. FIN 48 now requires such an analysis (on each reporting date) and prescribes separate reporting of (1) the deferred tax balance, based on the sustainable book/tax difference pursuant to FIN 48's recognition and measurement model, and (2) a FIN 48 liability for any "unrecognized" benefit.

Recognition

In applying FIN 48, companies will need to determine and assess all material positions taken in any income tax return as of the date they adopt FIN 48, including all significant uncertain positions, in all tax years that are still subject to assessment or challenge by relevant taxing authorities.

FIN 48 addresses the recognition and measurement of income tax positions using a "more-likely-than-not" (MLTN) threshold. The MLTN threshold means that:

- A benefit related to an uncertain tax position may not be recognized in the financial statements unless it is MLTN that the position will be sustained based on its technical merits; and
- There must be more than a 50 percent likelihood that the position would be sustained if challenged and considered by the highest court in the relevant jurisdiction.

Unit of Account

The determination of what constitutes an individual tax position (the unit of account) may directly affect the assessment of the uncertain tax position and is a matter of professional judgment. In making that determination, the financial statement preparer should consider:

- The level at which the entity accumulates information to support the tax return; and
- The level at which it expects tax authorities to address the issues during an examination.

Measurement

The tax benefit of a qualifying position is the largest amount of tax benefit that is more than 50 percent likely to be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. This poses potentially significant challenges in evaluating tax positions in various state, local, and foreign jurisdictions.

The following example, based upon Appendix A of FIN 48, illustrates the concept of measuring the "cumulative probability of occurring."

Assume a tax position has the following distribution pattern of possible benefit outcomes:

Possible Benefit Outcome	Percentage Probability of Successful Outcome	Cumulative Percentage Probability of Success
\$100 (complete success in litigation, or settlement with IRS)	10%	10%
80 (very favorable compromise)	20%	30%
60 (fair compromise)	25%	55%
40 (unfavorable compromise)	30%	85%
0 (total loss)	15%	100%

In this example, \$60 is the amount of tax benefit that would be recognized in the financial statements, because it represents the largest cumulative amount of benefit that is more than 50 percent likely to reflect the ultimate outcome.

Frequently one expected outcome will be clearly more probable than other possible outcomes, and determining the recognizable tax benefit will be possible without substantial effort.

Subsequent Recognition, Derecognition, and Measurement

Assessing an uncertain tax position begins with the initial determination of the position's sustainability. As of each balance sheet date, unresolved uncertain tax positions must be reassessed, and management should determine whether (1) the factors underlying the sustainability assertion have changed and (2) the amount of the recognized tax benefit is still appropriate. Developments—such as case law, changes in tax law, new rulings or regulations issued by taxing authorities, and interactions with the taxing authorities—could affect whether a position should be recognized or the amount that should be reported. A different assessment of the same information is not permitted; a different assessment must be supported by subsequent developments.

If the recognition threshold is not met initially, a company must recognize the benefit of the tax position in the first interim period that meets any one of the following conditions:

- a. The MLTN recognition threshold is met by the reporting date;
- b. The tax matter is ultimately settled through negotiation or litigation; or
- c. The period during which the relevant taxing authority may examine and challenge the tax position has expired.

Judgments concerning the recognition and measurement of a tax benefit might change as new information become available. Any change in the amount must be recognized by the company in the first period in which it no longer is MLTN that the tax position would be sustained upon examination. Using a valuation allowance is not permitted as a substitute for derecognizing the benefit.

If the preparer's assessment of the tax benefit to be recognized and measured changes as new information becomes available, the change in amount based on this judgment must be recognized as a discrete item in the period in which the change occurs. Unrecognized tax benefits should be recognized in the period in which the likelihood of the position reaches the MLTN threshold, which might occur prior to final resolution of the matter. Similarly, recognized tax benefits should be derecognized in the period in which the likelihood of the position falls below the threshold.

Interest and Penalties

A taxpayer is required to accrue interest and penalties that, under relevant tax law, the taxpayer would incur if the uncertain tax position ultimately were not sustained. Accordingly, under FIN 48, interest would start to accrue for financial statement purposes in the period in which it would begin accruing under the relevant tax law, and the amount of interest expense to be recognized would be computed by applying the applicable statutory rate of interest to the difference between the tax position recognized in accordance with FIN 48 and the amount previously taken or expected to be taken in a tax return. Penalties would be accrued in the first period in which the position was taken (or is expected to be taken) on a tax return that would give rise to the penalty. How a company classifies interest and penalties in the income statement is an accounting policy decision. The company should disclose that policy and the amounts recognized. Interest and penalties should be considered for tax benefit differences.

Classification

Unrecognized tax benefits and the related interest and penalty exposures usually will result in the recognition of a FIN 48 liability. That liability is not a component of deferred taxes. Also, the use of a valuation allowance is not an appropriate way to recognize a FIN 48 liability. Rather, the liability must be classified separately from other tax balances, based on the expected timing of cash payments to taxing authorities.

Liabilities resulting from FIN 48 are classified as long-term unless payment is expected within the next 12 months or the operating cycle, if longer.

Disclosures

One of the most controversial aspects of FIN 48 is the treatment of uncertain tax positions that fall below the MLTN threshold. Previously, under the SFAS 5 “liability approach,” a company might bundle together all of its uncertain positions and provide a general “cushion” or “reserve” against the possibility of losing some of the tax positions reflected on its returns for various jurisdictions.

FIN 48 requires a much more detailed analysis of a company’s tax positions. Each year, a company must provide, in tabular form on a worldwide aggregated basis, a reconciliation of the total amount of unrecognized tax benefits at the beginning of the period to the total amount of unrecognized tax benefits at the end of the period. FIN 48 also requires qualitative and quantitative disclosures, including:

- The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.
- The total amounts of interest and penalties (1) recognized in the statement of operations and (2) 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:
 - (1) The nature of the uncertainty
 - (2) The nature of the event that could occur in the next 12 months that would cause the change
 - (3) 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 open tax years by major jurisdictions.

Effective Date

FIN 48 becomes effective for fiscal years beginning after December 15, 2006. It requires an analysis of material tax positions in the tax accrual of all open years. In the transition period, the requirements of FIN 48 apply to the opening balance sheet of the first fiscal year subject to the new standard. The cumulative effect of applying the new requirements must be reflected as adjustments to the company’s retained earnings as shown on the opening balance sheet.

Calendar year businesses that report annually and are not SEC registrants may not have to reflect the results of FIN 48 analysis until they issue financial statements after the end of 2007, but they must review their uncertain tax positions as of January 1, 2007, so that they can make the adjustment at year-end.

Although FIN 48 is effective only for fiscal years beginning after December 15, 2006, SEC registrants may have earlier compliance requirements in quarterly filings. SEC registrants are required to disclose the effects of changes in accounting pronouncements under SEC Staff Accounting Bulletin [SAB] 74, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*. SEC Clients and their auditors and tax advisers may wish to review a Center for Public Company Audit Firms [E-Alert](#) on interim period disclosures.

Implications for Financial Statement Preparers

Evaluating a tax position in accordance with FIN 48 involves the following two-step process.

1. Recognition: The enterprise determines whether it is MLTN that a tax position will be sustained upon examination, including resolution of any related appeals or litigation, based on the technical merits of the position. In evaluating whether a tax position has met the MLTN recognition threshold, the enterprise should assume that (1) the tax position under consideration will be examined by the appropriate taxing authority and (2) the taxing authority has full knowledge of all relevant information. If this threshold is not met, none of the tax benefit provided by the position may be reflected in the financial statements.

2. Measurement: A tax position that meets the MLTN recognition threshold is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

To adopt FIN 48, the enterprise needs to identify its outstanding tax positions (for all open years) as of the beginning of the fiscal year in which it is adopting FIN 48. The FIN 48 recognition and measurement criteria must be applied to all open tax positions to estimate the transition amount at the effective date. In other words, on the first day of a reporting year beginning after December 31, 2006, the company must record the cumulative effect of FIN 48 issues.

Company accountants should confirm the company's policies and procedures related to positions in federal, state, local, and foreign tax returns and in the company's GAAP financial statements. It is important to have adequate documentation supporting tax positions taken in both the returns and financial statements, especially when using different thresholds. For example, accountants should be prepared to justify situations in which the return recognizes a benefit from a tax position but the financial statements do not because the position does not meet the MLTN recognition threshold for GAAP purposes.

The tax accrual will require an analysis of federal, state, local, and foreign income tax return positions for all open years to determine how much of a tax benefit may be claimed in the tax accrual and what "uncertain" positions must be disclosed in the financial statements. Financial statements may be requested by IRS auditors to determine if any positions in the tax accrual are "uncertain."

One **immediate action item** for financial statement preparers is to consult outside auditors and tax advisors to coordinate the FIN 48 analysis. This may involve setting up and maintaining an

inventory of tax benefits recognized and not recognized, and derecognized, as well as related interest and penalties until the period of assessments closes on them.

The tax accrual may require consultation with tax advisers.

Implications for Auditors

As stated previously, FIN 48 addresses the recognition, measurement, and disclosure of uncertain income tax positions recognized in an entity's financial statements. These positions are uncertain because they were either taken in a previously filed tax return that is still open to assessment and collection, or are expected to be taken in a future tax return and are reflected in the measurement of current or deferred income tax assets or liabilities.

These two conditions compel management to develop an estimate of the financial statement amounts related to the tax position (the estimate) because the exact amounts will not be known until the outcome of future events – for example, resolution by the IRS. AU Section 342, *Auditing Accounting Estimates*, defines an accounting estimate as an approximation of a financial statement element, item, or account, and provides guidance to the auditor on obtaining and evaluating evidence supporting significant accounting estimates incorporated in financial statements. Paragraph 10 of AU Section 342 states that the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches to evaluate the reasonableness of the estimate:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to the completion of fieldwork.

Approaches "a" and "b" generally will be the most practicable. Approach "c" generally will not be practicable because FIN 48 addresses uncertain tax positions – if a tax position has been resolved it no longer is uncertain. However, even though the tax position may not be resolved by the end of fieldwork, additional information may become available prior to the completion of fieldwork.

In reviewing and testing the process used by management to develop the estimate, and in auditing the financial statement accounts affected by the tax position, the auditor should:

1. Obtain knowledge about the entity's process for developing and reviewing the estimate by:
 - a. Inquiring of management and personnel involved in preparing and reviewing the estimate regarding:

- How the entity obtained the expertise needed to develop and evaluate the estimate, and its procedures for engaging outside specialists, if applicable.
 - The process for determining the best estimate, for example, how they assign probability values to various assumptions and possible outcomes.
 - How they consider or factor-in the effect on the estimate of variation in the underlying assumptions.
 - Who has final authority for reviewing and approving the estimate.
- b. Reading documentation of the process for preparing and reviewing the estimate.
2. Obtain an understanding of the entity’s controls as they relate to the preparation of the estimate. Aspects of an entity’s controls that are relevant to the process of developing and reviewing the estimate include controls designed to ensure that:
- a. The estimate and related disclosures conform to generally accepted accounting principles.
 - b. Relevant, sufficient, and reliable data are accumulated as a basis for developing the estimate.
 - c. The estimate is prepared and reviewed by qualified personnel. Such controls would include:
 - Hiring procedures and professional development activities to ensure that individuals responsible for developing and reviewing the estimate have the appropriate education, training, and experience.
 - Considering the need to use the work of an outside specialist in developing or reviewing the estimate.
 - d. The estimate is reviewed and approved by appropriate levels of authority.
 - e. The entity monitors the environment for changes in accounting standards and tax laws that might affect the estimate.
3. Perform procedures to test financial statement assertions related to the estimate, including:
- a. Identifying the factors, data, and assumptions used in developing the estimate.
 - b. Evaluating whether the factors, data, and assumptions used in developing the estimate:

- Are relevant and sufficient for the purpose of preparing the estimate, for example, whether there are alternative assumptions about the factors or additional key factors that management has not addressed.
 - Are reasonable by examining supporting evidence, for example, citations from tax laws (i.e., legislation, statutes, legislative intent, regulations, rulings, and case law) to the extent they are applicable to the facts and circumstances of the case. In addition, FIN 48 indicates that past administrative practices and precedents of the taxing authorities in its dealings with the entity or similar entities may be taken into account, such as routinely permitting the expensing items that are less than a specified amount even though they might technically be capital in nature.
- c. Evaluating whether interrelated assumptions are consistent with each other.
 - d. Evaluating the reasonableness of the range of possible assumptions that have been considered.
 - e. Reviewing available documentation of the data, factors, and assumptions used in developing the estimate.
 - f. Examining evidence that supports the timing of the recognition of the benefit, for example, evidence:
 - That the MLTN recognition threshold was met by the reporting date.
 - Of settlement through negotiation.
 - That the period of assessments for the relevant taxing authority to examine and challenge the tax position has expired.
 - g. Considering whether the assumptions appear to be relatively objective, that is, are not unduly optimistic or pessimistic.
 - h. Reperforming calculations used to translate the assumptions, data, and factors into the estimate.
 - i. Determining whether disclosure related to the estimate is complete; is supported by sufficient, appropriate evidence; and is in conformity with GAAP. An example is disclosure of uncertain tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will increase or decrease significantly within 12 months of the reporting date. In those circumstances, FIN 48 requires disclosure of the nature of the uncertainty, the nature of the event that could occur within 12 months to cause a change, and an estimate of the range of change or a statement that an estimate cannot be made.

If the client has obtained the advice or opinion of an outside tax adviser concerning the tax accrual or matters affecting it (including tax contingencies), this advice or opinion can be useful to the auditor in forming his or her own opinion. However, paragraph 20 of Interpretation No. 2, “The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals,” of AU Section 326, *Evidential Matter*, indicates that the auditor may not rely solely on the conclusions of the outside tax adviser. The audit of income tax accounts requires a combination of tax expertise and knowledge about the client's business that is accumulated during all aspects of the audit. Therefore, it is not appropriate for the auditor to rely solely on the opinion of an outside tax adviser. Paragraphs 20 through 23 of Interpretation No. 2 provide guidance to the auditor when the auditor disagrees with the opinion taken by the client or the outside tax adviser.

Implications for Tax Advisers

Under current procedures, IRS auditors do not (although the IRS could legally) request tax accrual workpapers, which would include the FIN 48 analysis, except when the taxpayer has entered into “listed transactions” under tax shelter rules. If two or more listed transactions are entered into, or if one listed transaction is entered into and there are also reported financial irregularities with respect to the taxpayer, IRS auditors are required by [IRM 4.10.20](#) to request all tax accrual workpapers. At this time, it is uncertain whether the prospect of such a thorough analysis might cause the IRS to modify its procedures or, alternatively, to further modify Schedule M-3 to include the required FIN 48 information in the book/tax reconciliation. This may deter entities from pursuing legitimate, aggressive tax strategies and move to a more-likely-than-not standard for tax planning, even though this is a higher standard than is required for positions taken in tax returns to avoid IRS penalties.

For calendar-year corporations, the new rules require a “clean” starting point for their tax accounts at January 1, 2007 or disclosure of any “uncertain” tax positions. The IRS has offered [guidance](#) to help taxpayers expeditiously resolve uncertain positions to assist in implementing FIN 48. But, as of now, few taxpayers have availed themselves of this IRS initiative.

FIN 48 addresses the issue of returns that have not been filed, such as when a decision has been made not to file in a particular state where there is limited nexus. An open period of assessments for an unfiled return would have to be considered in a FIN 48 analysis, with the assumption that the taxing authority would know the relevant facts. If all income has been allocated to other states, the taxes have been paid, and the period of assessments has expired in those states, there might not be the possibility of an offsetting allocation from those states for the income in the state in which the statute has not yet expired. If it is reasonably possible that the total amount of unrecognized tax benefits will increase or decrease significantly within 12 months of the reporting date, the financial statement must disclose the nature of the uncertainty, the nature of the event that could cause the change, and an estimate of the possible change, but may not have to disclose the particular jurisdiction.

Tax advisers will be asked to assist both financial statement preparers and auditors in the analysis of the likelihood of success of uncertain positions in the tax accrual. This will require a weighing of authorities and an analysis of the ultimate likelihood of success of different levels of

tax benefits based on different tax strategies. Clients may be reluctant to undertake tax planning strategies that, while meeting the requirements for avoidance of IRS penalties and sanctions, may nonetheless have to be disclosed in the financial statements. In an audit, the IRS will likely request copies of financial statements, and disclosures of “uncertain” positions will be the likely focus of attention for examination. The disclosures on Schedule M-3, combined with those required by FIN 48, will provide the IRS with an unprecedented level of information about a company’s tax positions. In addition to deterring the pursuit of legitimate tax positions, FIN 48 may eliminate the need for “should” opinion letters, with most taxpayers going to the FIN 48 MLTN standard.

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The AICPA is providing FIN 48 practice support for financial statement preparers, auditors, and tax advisers, and you can learn more or sign up by clicking the link for the updated [CPE course](#) on accounting for income taxes and the [webcast](#) on FIN 48. Tax Section members can discuss FIN 48 issues in [forums](#) at the Tax Center website.