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"CFO's Strategic Role in Managing Rising Tax Risks: What the CFO has to curb, rethink and forget"

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FASB Interpretation No.48, Accounting for Uncertainty in Income Taxes

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Agenda

Overview

Scope and Unit of Account

Recognition and measurement

Classification

Summary

Overview

- Prior to recognising the benefit of a tax position for financial reporting purposes, the tax position must be more-likely-than-not (MLTN) of being sustained based solely on its technical merits
- Tax positions to be recognised are reported at the largest amount that is MLTN to be realised
- Tax positions not eligible for benefit recognition are generally recorded as a liability for financial reporting purposes

Scope of FIN 48

- FIN 48 applies to <u>all</u> tax positions within the scope of SFAS 109
  - FIN 48 does not apply to other (non-income) taxes (such as property or sales taxes)
- Tax positions include:
  - Deductions taken (or expected to be taken)
  - Taxable income excluded or recharacterised (or expected to be excluded or recharacterised)
  - Conclusions to not file an income tax return
  - Conclusions that an entity or transaction (e.g., a reorganisation) is tax-free

Step 1a: Identify Tax Positions

- Bottom-up inventory approach
  - Identify, evaluate and measure material tax positions
  - "Roll forward" each jurisdiction's inventory of tax positions - add originating tax positions and remove settled tax positions
- Consider risk of understatement

Unit of Account

- When applying the recognition and measurement provisions of FIN 48 the unit of account may be the tax position (in total) or may be an element thereof
- Determining the unit of account is dependent upon the specific facts and circumstances of the entity
  - The manner in which the tax return is prepared and supported
  - The expected approach the taxing authority will take during an examination of the tax position.
  - Increased disaggregation of specific deductions may be required
  - The unit of account drives the application of FIN 48 recognition and measurement

Step 1b: Determine Unit of Account

- Aggregate
- Disaggregate
  - May significantly affect amount of effort and documentation
- Similar tax positions should have similar units of account

Example: Determine Unit of Account

- Company incurs $100 of R&D costs eligible for a tax credit
- Unit of account might be:
  - Entire $100 cost pool
  - Breakdown by project
    - Project A $40
    - Project B $35
    - Project C $25
  - Breakdown by department
    - Engineering $60
    - Quality control $25
    - Innovation $15
  - Breakdown by geography

Example: Determine Unit of Account (cont'd)

- Consider FIN 48 example of R&D (paragraphs A5-A7)
  - Determining whether a project is "qualifying" is binary; it either qualifies or it does not
  - If it is a qualifying project, the taxing authority may challenge other aspects of the R&D credit to reduce the amount of realised credit
  - Consider statutory requirements for R&D credit: documentation, nature of project, base period computations, cost allocations, and transactions

Step 2: Evaluate Tax Position for Recognition

- In order to recognise <u>any</u> amount of benefit, for the unit of account, the position must be MLTN of being sustained
  - The position will be examined
  - The examiner will have full knowledge of all relevant information
  - Evaluation based solely on the technical merits
  - No offset or aggregation of positions
  - Conclusion should assume resolution in the court of last resort

Recognition

- Unit of account drives evaluation
  - Disaggregating a tax position may result in the need for additional evidence / documentation
    - For example, evaluating the project underlying a R&D credit requires one evaluation. Evaluating each transaction comprising a R&D credit requires many evaluations
- Conclusion is a positive assertion

Recognition (cont'd)

- Highly certain tax positions
  - Clear and unambiguous tax law
  - Consistent with "will prevail" opinion
  - Effect of benefit recognition (asset) approach
  - Extent of evidence and documentation requires judgment

Recognition (cont'd)

- Evidence and documentation
  - Nature of position
  - Capabilities of company tax specialists
  - Third-party experts
    - Tax opinions
    - Other written or oral advice
  - Role of the auditor

Step 3: Measure Benefit to be Recognised

- "Cumulative Probability" assessment
- A tax position to be recognised is measured (reported) at the largest amount of benefit that is greater than 50% likely of being realised

Estimated Outcome	Individual Probability (%)	Cumulative Probability (%)
$100	35	35
$ 75	25	60
$ 50	40	100

Measurement (cont'd)

- Assigning probabilities
  - Highly judgmental
  - Basis for probabilities
    - Amount reflected in the tax return
    - Company experience / history with similar positions
    - Expert advice
    - Other
  - Should assess probability of the amount of the (as-filed) deduction being realised
- Documentation and evaluation of probabilities assigned
  - Processes, procedures and systems and controls

Measurement (cont’d)

Assumptions to be used

Recognition		Measurement	
1.	The position will be examined (i.e., no detection risk)	1.	Same
2.	The examiner will have full knowledge of all relevant information	2.	Same
3.	Evaluation based solely on the technical merits	3.	Same
4.	No consideration offset or aggregation of positions	4.	Same
5.	**Conclusion should assume resolution in the court of last resort (e.g., US Supreme Court)**	**5.**	**Conclusion depends on enterprise’s plan for settlement**

Step 4: Prepare Disclosures

- Description of open tax years by major jurisdiction
- Qualitative and quantitative disclosures of unrecognised tax benefits that are reasonably possible of changing
- Tabular reconciliation of the beginning and ending balances of unrecognised tax benefits
- Amount of unrecognised tax benefits that will change the effective tax rate
- Classification and amount of interest and penalties