NEWS ANALYSIS:

Uncertainty All Around:
FIN 48 at NTA’s Spring Symposium

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Recent changes to financial reporting rules designed to resolve some of the uncertainty in income tax positions might conversely bring about more uncertainty than expected.

That possibility was one of the implications Lillian Mills of the University of Texas highlighted during her presentation on Financial Accounting Standards Board Interpretation No. 48, “Accounting for Uncertainty in Income Taxes,” at the recent National Tax Association’s annual spring symposium in Washington. FIN 48 requires firms to adopt new methods to account for uncertainty in their income taxes and to disclose detailed information in their financial statements about how much they have set aside in their tax reserve accounts in case the tax authorities do not accept their tax position. (For more details, see a forthcoming National Tax Journal article by Jennifer Blouin, Cristi Gleason, Lillian Mills, and Stephanie Sikes: “What Can We Learn About Uncertain Tax Benefits From FIN 48?” The author thanks Mills for her assistance.)

Many analysts believe the new rules will dramatically change how firms acknowledge the extent of the uncertainty about their income tax liabilities. “FIN 48 creates asymmetric incentives for firms to release any excess reserves — the ‘tax cushion’ — to earnings before adoption, because otherwise adjustments go straight to the balance sheet via shareholders equity,” Mills explained.

For example, suppose that before FIN 48, a firm had set aside a large tax reserve to pay the government in case the IRS “won” and required the company to pay additional taxes on this previously sheltered income. Under the new rules, if the firm now believes that the government is at least likely to accept its position, it will have to reduce the reserves that it has set aside for unrecognized tax benefits. In contrast, if a firm has not been as conservative in accounting for its reserves, it will probably increase its reserves under FIN 48. Thus, FIN 48 could lead to substantial upward or downward revisions in corporate tax reserves in 2007.

Uncertainty Over Impact

Those changes to reserve amounts may be innocuous if the firm has taken a relatively noncontroversial tax position. For example, although there may be some uncertainty about the value of a depreciation deduction, there is likely to be little difference between what the company claims and what the tax authorities ultimately accept. By contrast, the company and the IRS may differ significantly about the reserves set aside for more controversial positions, such as the amount of income attributed to a tax shelter or a transfer pricing allocation. In those cases, corporate tax departments may be concerned that FIN 48 will increase their chances of becoming subject to a tax audit.

The implications of FIN 48 go beyond reporting the uncertainty over tax liability; they also affect the assumption about whether the taxing authority learns about the tax scheme. Under the old rules, the firm could have played the “audit lottery” and built into its estimated tax benefit the assumption that the IRS might never find out about its aggressive tax schemes. Because the firm must now assume that the IRS will have full knowledge of all relevant information about the tax position, the firm may no longer act as if the IRS does not know the tax shelter exists.


— Joann M. Weiner

TIMING IS EVERYTHING IN MULTINATIONALS’ REPATRIATION PATTERNS

During a recent international session at the National Tax Association’s annual spring symposium in Washington, Treasury economists Laura Power and Gerald Silverstein presented their study on the repatriation patterns of U.S. multinational corporations, with a focus on finding out whether companies with loss-making foreign subsidiaries have a different repatriation pattern from profitable companies.

Power and Silverstein found that multinational companies in their study were able to time their repatriations to minimize their taxes. Specifically, firms in a loss position preferred to repatriate income when they had positive profits, rather than lose the benefits of the net operating loss deduction.
The uncertainty over exactly what effect FIN 48 will have on corporate earnings is creating unease in many areas. That uncertainty led Drew Lyon, an economist with PricewaterhouseCoopers National Economics Consulting, to quip: “We thought that Ben Franklin had it right when he said that the only thing certain is death and taxes. Unfortunately, he did not appear to take into account the uncertainty over these ‘certain’ taxes.”

**Why FASB Acted**

Under the old rules, if a company claimed a tax deduction for an income sheltering scheme that it nevertheless did not believe the IRS was likely to sustain in full, it would have set up a tax reserve for some portion of the tax deduction. The controlling rules under Statement of Financial Accounting Standards No. 109, “Accounting for Income Taxes,” however, provided no guidance on how the company should compute the amount of uncertainty in its income taxes.

SFAS 109 did allow companies to create a “slack” in their tax reserves that they could adjust during different phases of the business cycle to reduce the volatility in the income reported to shareholders. Companies could increase or decrease their reported income by reducing or increasing their tax reserves, respectively. Because companies faced no penalties when using their reserves in that manner, they had little incentive to curb the practice when it benefited their bottom line.

Many analysts suspected that companies “managed” their tax reserves to smooth earnings or strategically reduced their tax expenses to reach analysts’ forecasts.

“The old rules allowed companies to dip into the reserve cookie jar whenever they needed to manage their earnings,” Mills explained.

The rules also did not reflect the fact that companies faced a great deal of uncertainty regarding their final tax liability. That type of uncertainty over the final tax position regularly arises, yet companies did not have to provide shareholders any detailed information regarding the likelihood that their tax position would be sustained.

**How FIN 48 Works**

FIN 48 addresses that situation by requiring companies to provide more transparency regarding their uncertain tax positions. Under FIN 48, a company must first identify its uncertain tax position and then determine for each tax position whether it is “more likely than not” that the IRS (or any other tax authority) will sustain that position on audit, examination, or further investigation. If the position is more likely than not to be sustained, the company estimates how much of the tax benefit to recognize in its financial statements. That amount is the largest benefit that the company has a more than 50 percent chance of realizing on final settlement.

If the courts are not likely to accept the tax position, the firm may not book any tax benefit from that position.

FIN 48 applies to all tax positions, including:

- a decision not to file a tax return;
- an allocation or a shift of income between jurisdictions;
- the characterization of income or a decision not to report taxable income in a tax return; and
- a decision to classify a transaction, entity, or other position in a tax return as tax exempt.

The following table gives an example of how a company might determine the size of the tax benefit under the more likely than not cumulative probability standard of FIN 48, drawing from an example prepared by Deloitte.

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<th>Possible Estimated Outcome ($)</th>
<th>Individual Probability of Occurring (%)</th>
<th>Cumulative Probability of Occurring (%)</th>
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Under the cumulative probability approach of FIN 48, the company should record a $30 tax benefit because even though the benefit has only a 20 percent chance of occurring, it has a cumulative probability of 51 percent. Therefore, that benefit meets the more likely than not standard.

However, under other valuation methods, such as probable outcome, the firm could have reported a $40 tax benefit because that benefit was the most probable outcome. The firm also could have valued the tax benefit as a weighted average of all possible outcomes, recording a $24 tax benefit. Thus, although FIN 48 leaves room for considerable judgment regarding the cumulative probability of an
event’s occurring, it applies a consistent valuation method to measuring uncertain benefits.

**Drawing Authorities’ Attention**

Noting that one reason for a large tax reserve may be the existence of an aggressive tax position, Mills said the new rules for accounting for uncertainty in income taxes could lead to increased audits by the IRS.

Korb has said the IRS won’t ‘turn a blind eye’ to public financial disclosures, but he recently said the agency is continuing its policy of restraint in requesting tax accrual workpapers.

Three days after the NTA conference, IRS Chief Counsel Donald Korb seemed to confirm that possibility when he indicated that the IRS would use the new information to determine where it should take a closer look. Speaking at a May 21 conference in New York sponsored by tax consultants Seigel & Associates LLC, Korb said the IRS won’t “turn a blind eye” to publicly available tax disclosures in financial statements submitted to the Securities and Exchange Commission. The IRS would be right to take a closer look at a company that, following an IRS exam, “frees up a huge amount of reserves,” he said. (For coverage, see *Tax Notes*, May 28, 2007, p. 812, Doc 2007-12363, or 2007 TNT 99-4.)

Although there had been some uncertainty about the status of the IRS’s current policy of restraint when requesting tax accrual workpapers, Korb confirmed that the IRS is continuing its policy of restraint outside listed transaction cases. The IRS is expected to provide guidance soon on that policy.

**Company Responses to the New Rules**

In a review of more than 200 financial reports, Mills and her coauthors studied disclosures related to the uncertain tax benefits for the 100 largest nonfinancial companies. They found that those firms had recorded $82 billion in reserves (plus $13 billion in interest and penalties) for uncertain tax benefits, or about 2 percent of assets, as of January 1, 2007. That $82 billion included interest expense for some firms; without interest expense the reserve balance is closer to $78 billion. Earnings would permanently increase by about $58 billion if the uncertainty were resolved in the taxpayers’ favor.

Their examination of SEC 10-Q and 10-K filings as of May 15 found a rough balance between companies that increased their reserves and those that decreased their reserves. Dow Chemical and Wyeth, for example, each increased their reserves by nearly $300 million. Ford Motor Co. had the largest reduction in reserves — $1.3 billion, or 76 percent, leading to a $137 million increase in retained earnings. Altria reduced its reserves by $857 million.

With $7.4 billion in reserves (nearly 17 percent of assets) including interest, or $5.1 billion excluding interest, Merck & Co. had the largest level of reserves at the beginning of the year among the companies studied. As Merck reported in its 10-Q filing on May 8, its liability for unrecognized tax benefits fell to $5.01 billion as of March 31. Merck noted that if it were to recognize those benefits, “the effective tax rate would reflect a favorable net impact of $3.95 billion.” As of March 31 the company reflected a liability for unrecognized tax benefits of $3.44 billion. If the company were to recognize those benefits, its effective tax rate would reflect a favorable net impact of $2.38 billion.

Merck reports, however, that although it anticipates that the amount of unrecognized tax benefits will change over the next year, “these changes are not expected to have a significant impact on the results of operations, cash flows, or the financial position of the Company.” (See Tax Analysts’ *Financial Reporting Watch* for a list of companies’ latest earnings reports and SEC filings.)

Although most firms that reported changes in reserves reduced them, Mills and her coauthors found no initial evidence that the changes are significantly different from those made in prior years. Thus, it is possible that the Sarbanes-Oxley Act of 2002 is working as intended — making earnings management more difficult. Mills and her coauthors are extending the descriptive analysis to test reporting incentives before and after FIN 48 took effect.

**Foreign, State Authorities Also Want Answers**

Another uncertain consequence of FIN 48 is the increased scrutiny that foreign and state tax authorities may apply to firms’ tax reserves.

Because a firm must report the tax benefit based on its expected ultimate settlement, it must examine developments in the courts and legislatures in all of the jurisdictions where it does business to determine the likelihood that a position will be sustained and, if so, at what amount.

For large multinational companies, that situation could lead to substantial uncertainty about the amount of tax benefit that the company may realize. Merck, for example, reported in its recent SEC filing that tax years remain subject to examination in major tax jurisdictions, such as Germany (from 1999), Italy and Japan (from 2000), and the U.K. (from 2002).

To illustrate, Merck made the following point in its recent SEC filing concerning its exposure in Canada. The Canada Revenue Agency is examining...
Merck’s tax returns for 1998-2004, and in October 2006 the agency issued a notice of reassessment concerning some intercompany pricing matters that resulted in approximately $1.4 billion in additional Canadian and provincial tax due. The company disagrees with the positions taken by the CRA and believes the reassessments are without merit, as stated in its Form 10-Q:

While the resolution of these matters may result in liabilities higher or lower than the reserves, management believes that resolution of these matters will not have a material effect on the Company’s financial position or liquidity. However, an unfavorable resolution could have a material effect on the Company’s results of operations or cash flows in the quarter in which an adjustment is recorded or tax is due.

State Tax Issues

FIN 48 also affects how companies estimate their potential state income tax liability. Multistate companies may be concerned that state tax authorities will interpret a reported tax reserve as indicating that the company believes it has a taxable presence in the state, even though there is significant uncertainty around exactly what constitutes nexus for state income tax purposes.

For example, in its request for a delay in implementing FIN 48, the Council On State Taxation noted that the new rules created complicated issues concerning nexus for the more than 45 states and several local jurisdictions that impose a tax covered by FIN 48. As COST explained in its January letter to FASB, given the uncertainty over what determines nexus in each state, “numerous taxpayers will be required to reserve the full 100 percent of the ‘potential’ tax liability in locations where they do not currently believe they have nexus, but might in the future depending on how the law shakes out over the coming years (decades).” (For the letter, see Doc 2007-670 or 2007 STT 7-2.)

That situation could become precarious for companies that have not filed a state tax return because they determined that they do not have a taxable presence. If state law later clarifies that the company did have a taxable presence, the company will be liable for taxes and penalties for the entire open period.

The U.S. Supreme Court may also have the opportunity to weigh in on that issue if it accepts the MBNA and Lanco cases, which deal with taxable nexus. In their petition, some business groups argue in favor of establishing a physical presence test for determining whether a taxable nexus exists for state tax purposes. They argue that not doing so could diminish the quality of financial statement reporting as companies attempt to determine whether they have a sufficient economic presence to be subject to a state’s tax and, therefore, to estimate their tax benefit as required under FIN 48. (For the groups’ amici brief in FIA Card Services N.A. et al. v. Tax Commissioner of the State of West Virginia et al., see Doc 2007-11540 or 2007 STT 92-17.)

Huddleston noted that under FIN 48, companies are required for financial reporting purposes to track tax positions that fail to meet the “more likely than not” threshold of being sustained on audit by tax authorities. For state tax reporting purposes, companies must determine whether their tax liability is properly allocated to a particular state or apportioned among multiple states, he said. Those very different reporting goals ultimately mean that while the disclosure of an uncertain tax position in a financial statement might raise a red flag for a state tax authority, the income affected by an uncertain tax position may not necessarily be taxable in that state, he said.

— Carolyn Wright LaFon
The groups suggest that the new rules under FIN 48 will require companies with no physical presence in the state to estimate their state tax liabilities based on their best estimate of whether the tax authorities will later assert nexus based on their economic presence. For example, companies that have customers or an intangible presence in a state but have no physical presence there must evaluate whether it is more likely than not that the state tax authority will agree that a mere economic presence does not create nexus and, therefore, the company is not required to file a state tax return. However, if the state tax authority asserts that economic presence creates a taxable nexus, then the presence of the company’s customers or intangible property may make the company liable for state income taxes. Because the statute of limitations does not begin to run until a company files its return, the company may be exposed to a state liability for an indefinite period.

The Uncertainty Continues

Because firms have just started reporting the impact of the new FIN 48 rules, it is too soon to determine whether FIN 48 will cause aggregate reported corporate earnings to be greater or lower than under the old rules. What does seem to be certain, however, is that the increased disclosure about the uncertainty behind the income tax reserves will greatly help analysts evaluate the financial health of a company.

Combining this greater transparency on the possible existence of tax shelters with the greater information provided through the new reconciliation table (Schedule M-3) of the corporate income tax return will help the IRS identify areas where firms reduce their taxable income below their book income. (For related coverage, see Tax Notes, May 28, 2007, p. 849, Doc 2007-11679 or 2007 TNT 104-46.) Given the accounting debacles in the early 21st century, obtaining greater transparency in financial reporting can only benefit the investment community.

Jackson Hewitt Under Investigation

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Nearly two months after the Justice Department filed an injunction against franchisees of Jackson Hewitt for alleged tax return fraud, the tax return preparation firm itself is now under investigation by the IRS.

In a May 31 Securities and Exchange Commission filing, Jackson Hewitt said it recently learned that the IRS “is conducting additional examinations of tax return preparation activities of Jackson Hewitt franchisees and company owned stores” and that the company itself “is also a subject of an IRS examination relating to these matters.” The firm added that it is cooperating with IRS investigators. (For the SEC filing, see Doc 2007-13484.)

The Justice Department in early April announced that it was filing suit against five corporations to stop tax return preparation at more than 125 Jackson Hewitt franchises in four states, alleging that as many as 30,000 of the 105,000 returns filed by the franchises in 2006 were inaccurate or fraudulent. According to Justice, many of the franchises stopped verifying information such as Forms W-2, helped taxpayers inflate refunds by claiming false deductions, and even received kickbacks from customers. The IRS at that time estimated that the fraud cost the Treasury as much as $70 million. (For prior coverage, see Tax Notes, Apr. 9, 2007, p. 95, Doc 2007-8689, or 2007 TNT 65-1.)

After Justice announced its suit, Jackson Hewitt began an internal review, headed by former IRS Commissioner Fred Goldberg, a partner at Skadden, Arps, Slate, Meagher & Flom LLP. (For coverage, see Doc 2007-9008 or 2007 TNT 68-2.) Shortly