Lifting the Veil on Tax Risk --- New Accounting Rule Lays Bare A Firm's Liability if Transaction Is Later Disallowed by the IRS

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Hundreds of companies could be on the hook to the Internal Revenue Service and other authorities for tens of billions of dollars in back taxes due to transactions they believe could be challenged, newly required regulatory disclosures show.

Investors are getting a first peek into one aspect of the world of corporate taxes, thanks to a new accounting rule that took effect in January.

The rule, known as FIN 48, forces companies to better disclose how much they have set aside, or reserved for financial-reporting purposes, to pay governments in case tax-saving transactions are successfully challenged by taxing authorities.

In the past, companies had to reveal little information about transactions that could face some risk in an audit by the IRS or other government entities. Now, companies are being required to disclose the amount they have put into tax reserves, along with other potentially challengeable amounts related to past tax benefits. These sums are being disclosed as a liability for "unrecognized tax benefits" in quarterly 10-Q reports filed with the Securities and Exchange Commission. Most of the first such disclosures have been filed in the past few weeks.

A pair of new research papers, one by a group of accounting professors and the other by a pair of tax analysts at Credit Suisse Group, examine the new tax information, laying out how much money could be at stake.

The 361 large companies studied by Credit Suisse reported a combined $141 billion in such tax liabilities. To be sure, these aren't necessarily related to aggressive tax transactions. Also, extra payments and refunds are part of the normal back-and-forth between corporations and tax authorities.

As of Jan. 1, the company that could be on the hook for the biggest amount is Merck & Co., which had a potential tax liability of $7.4 billion, according to Credit Suisse tax and accounting analysts David Zion and Amit Varshney.


Here is what the disclosures mean: Say a company saves $100 million on its taxes -- as a result of a tax credit, a tax shelter or some other transaction. However, the company is not completely sure that those savings will withstand scrutiny if it gets audited, so for financial-accounting purposes, it sets aside $40 million of those tax savings in a reserve. There is no requirement the actual cash be set aside. On its income statement, the company gets only a benefit of $60 million -- or $100 million minus the $40 million set in reserve.

Until now, there was generally no way to know about the existence of that transaction or reserve. But the new accounting rule establishes fresh guidelines for creating such reserves, and also requires companies to disclose them as liabilities for "unrecognized tax benefits." (The category is so named because it represents the portion of the tax benefits realized on a company's tax return that hasn't been recognized in its financial reporting.) This new category also includes other things besides reserves, including tax positions in which the timing of the benefit may be challenged, such as a depreciation-related deduction.

For investors, those "unrecognized tax benefits" can be significant, because they provide a quantitative...
measure of the amount the company thinks might be at risk -- in cash -- if the IRS or another tax authority challenges it and prevails.

Credit Suisse's analysts note that taking tax positions that could be subject to a challenge by the government can help a company's cash flow in the short term, but puts the firm at risk of having to make big payouts later.

"The question for investors," they wrote, "is are you willing to pay for companies to take on this type of risk?"

Merck's reserve has dropped by about one-third since the start of the year, to $4.9 billion. The reason: In February, Merck announced a net $2.3 billion settlement with the IRS. Part of that payment stemmed from a Bermuda tax shelter used by Merck that was the subject of a page-one article in The Wall Street Journal last year. In a statement, a Merck spokeswoman said: "Based on Merck's particular business situation and the time period covered, the company's tax reserves are reasonable."

Pharmaceutical companies like Merck often get big tax benefits from "transfer pricing" -- the methods companies use to allocate costs and revenue between different tax jurisdictions. Merck is in the middle of a $1.87 billion transfer-pricing dispute with the Canada Revenue Agency, according to its SEC filings and a person familiar with the matter.

The new disclosures aren't perfect. For one, the amount a company reserves against a tax benefit comes from a subjective management estimate. Different companies could reserve different amounts for the same transaction. Plus, a new tax bill in one jurisdiction could trigger a new tax deduction or credit elsewhere. But it isn't always clear if the number disclosed by some companies is a net or a gross figure. Several companies, including AT&T, J.P. Morgan, Citigroup and GE, include significant amounts in their total unrecognized tax benefits that would be partially offset by deductions arising from the new payments or are related to timing.

The absolute number contained in the reserve also doesn't tell the full story about future tax risk. Mr. Zion compared the newly disclosed tax liability with other metrics, like companies' average cash flow or their total liabilities. Based on that analysis, Mr. Zion found the companies most at risk if they get hit with a big demand for back taxes are PMC-Sierra Inc., Altera Corp., General Motors Corp. and Merck.

The unrecognized tax benefit at PMC-Sierra, for example, is equivalent to about 13 years' worth of its typical cash flow from operations, according to Credit Suisse. A PMC-Sierra spokesman didn't return phone messages.

A coming study by four accounting professors -- Jennifer Blouin of the University of Pennsylvania, Cristi Gleason of the University of Iowa, and the University of Texas' Lillian Mills and Stephanie Sikes -- examined the newly disclosed tax liabilities at 100 large companies and compared those with their book assets. Merck's total unrecognized tax benefit topped the list under that analysis, too, with an amount equal to 16.6% of its assets.

By contrast, GE's total unrecognized tax benefit was a similar size, but it represented about 1% of its total assets. GE's reported $6.8 billion liability doesn't include $1.4 billion in accrued interest and penalties. An Exxon Mobil spokesman said its unrecognized tax benefit of $3.7 billion represented a fraction of last year's tax bill of about $30 billion.
Taxman Coming?
Companies reserve a portion of tax savings in case they don't fully fly with tax authorities. Companies now must disclose that amount. Ten companies with the biggest "unrecognized tax benefits":

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Merck &amp; Co.</td>
<td>$7.4 billion</td>
</tr>
<tr>
<td>General Electric¹</td>
<td>6.8</td>
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<tr>
<td>AT&amp;T</td>
<td>6.3</td>
</tr>
<tr>
<td>J.P. Morgan Chase¹</td>
<td>4.7</td>
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<tr>
<td>Pfizer²</td>
<td>4.6</td>
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<tr>
<td>Exxon Mobil¹</td>
<td>3.7</td>
</tr>
<tr>
<td>Bank of America</td>
<td>3.5</td>
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<tr>
<td>Wells Fargo</td>
<td>3.1</td>
</tr>
<tr>
<td>Citigroup¹</td>
<td>3.1</td>
</tr>
<tr>
<td>Verizon Comm.</td>
<td>3.0</td>
</tr>
</tbody>
</table>

¹Amounts do not include accrued interest and penalties; ²As of April '07

Sources: Credit Suisse; WSJ research

Note: As of Jan. 1, '07