Politics & Economics: How Accounting Rule Led to Probe --- Disclosure of Tax Savings Firms Regard as Vulnerable Leaves Senate Panel a Trail

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602 words
11 September 2007
The Wall Street Journal
A5
English
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Senate investigators, ratcheting up the pressure on corporate tax-cutting transactions, have sent letters to at least 30 companies seeking details of past tax arrangements.

Companies that have received such letters include Merck & Co., Johnson & Johnson and Wyeth, according to a person familiar with the matter. Representatives for Merck and Johnson & Johnson said the companies were in the process of responding to the Senate request. A Wyeth spokesman wouldn't comment.

The probe, by the Senate's Permanent Subcommittee on Investigations, appears to have been sparked by an accounting rule known as FIN 48, which took effect in January. The rule for the first time requires companies to disclose how much they have set aside to pay tax authorities if certain tax-cutting transactions are successfully challenged by the government. The disclosures require companies to attach a dollar figure to tax-savings arrangements they think could be vulnerable.

Although intended to inform investors, the disclosures also serve as a kind of road map for government authorities, guiding them to companies that may have taken an aggressive stance on tax-related arrangements.

The FIN 48 disclosures generally reveal how much a company has set aside in an accounting reserve called "unrecognized tax benefits." The reserve represents the portion of the tax benefits realized on a company's tax return that also hasn't been recognized in its financial reporting.

In the letters, sent Aug. 23, Senate investigators seek to obtain more details about the underlying transactions in the FIN 48 disclosures. One letter viewed by The Wall Street Journal asks the companies to "describe any United States tax position or group of similar tax positions that represents five percent or more of your total [unrecognized tax benefit] for the period, including in the description of each whether the tax position involved foreign entities or jurisdictions."

The subcommittee, led by Sen. Carl Levin (D., Mich.), has held numerous hearings on tax shelters, tax avoidance, and the law firms and accounting firms that set up such structures.

The Senate's inquiry also includes questions about other tax-cutting arrangements. For tax-cutting transactions on which companies spent at least $1 million for legal fees or other costs, Senate investigators are asking companies to identify the amount of the tax benefit, as well as "the tax professional(s) who planned or designed the transaction or structure and the law firm(s) that authored the tax opinion or advice."

The inquiry was reported in late August by BNA Daily Tax Report, a tax trade publication.

It isn't clear what prompted the committee to focus on any particular company. However, some companies that have received letters have made FIN 48 disclosures that stand out. Merck, for instance, initially disclosed a potential tax liability of $7.4 billion, which was the largest absolute such figure reported by 361 large companies studied in a May report by tax and accounting analysts at Credit Suisse Group.

Many companies recorded sizable increases to their tax reserves upon adoption of the new accounting rule -- an indication they had recorded larger tax savings from certain transactions under the previous rules. For instance, Wyeth recorded the single largest increase to its reserves upon adopting FIN 48 of 100 companies studied by four accounting professors at the University of Pennsylvania, the University of Iowa and the University of Texas. The study didn't include financial-services firms or utilities.