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FASB Issues Final Interpretation Regarding Accounting for Uncertain Tax Positions

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20183] July 14, 2006 TO: ACCOUNTING/TREASURERS MEMBERS No. 14-06 TAX MEMBERS No. 24-06 ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 8-06 RE: FASB ISSUES FINAL INTERPRETATION REGARDING ACCOUNTING FOR UNCERTAIN TAX POSITIONS The Financial Accounting Standards Board ("FASB") has issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"), which clarifies FASB Statement No. 109, Accounting for Income Taxes.1 The Interpretation sets forth a specific recognition threshold and measurement method for the financial statement recognition and measurement of a tax position taken or expected to be taken on a tax return. It also provides guidance on classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Interpretation amends FASB Statement No. 5, Accounting for Contingencies, by indicating that it no longer applies to accounting for income taxes. The Interpretation is effective for fiscal years beginning after December 15, 2006. The final Interpretation contains a number of changes from the Exposure Draft that was issued in August 2005.2 Most significantly, the Interpretation requires a two-step method for evaluating uncertain tax positions: (i) satisfaction of a recognition threshold, followed by (ii) measurement of the amount of benefit that may be recognized. Further, the Interpretation replaced the "probable" standard for recognition contained in the Exposure Draft with a "more-likely-than-not" standard as recommended by the Institute.3 The Interpretation applies to all tax positions taken by both public and nonpublic companies. The term "tax position" refers to a position in a previously filed tax return or a position expected to be 1 FIN 48 is available on the FASB's website at: http://www.fasb.org/st/index.shtml#int48. 2 See Memorandum [19071] to Accounting/Treasurers Members No. 12-05 and Tax Members No. 20-05, dated August 5, 2005. 3 See Memorandum [19148] to Accounting/Treasurers Members No. 17-05 and Tax Members No. 24-05, dated September 12, 2005. 2 taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term also includes: (i) a decision not to file a tax return; (ii) an allocation or a shift of income between jurisdictions; (iii) the characterization of income or a decision to exclude reporting taxable income in a tax return; and (iv) a decision to classify a transaction, entity, or other position in a tax return as tax exempt. Recognition The first step of the evaluation process set forth in the

Interpretation is recognition. The recognition threshold requires one to determine whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The term “more likely than not” means a likelihood of more than 50 percent. The determination of whether or not a tax position has met the more-likely- than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date. The technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position. In evaluating whether a tax position has satisfied the recognition threshold, one should presume that the position will be examined by the appropriate taxing authority, which will have full knowledge of all relevant facts. Past administrative practices and precedents of the taxing authority in its dealings with the company or similar companies, when such practices and precedents are widely understood, may be taken into account in making this evaluation. In other words, if it is broadly understood that the relevant taxing authority does not object to a certain tax position, even if the tax law supporting that position is unclear, the company may treat that position as satisfying the recognition threshold. FIN 48 notes that a legal tax opinion need not be obtained to demonstrate that the recognition threshold has been satisfied. The Interpretation indicates that a tax opinion can be external evidence supporting a management assertion; management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law. Other evidence, in addition to or instead of a tax opinion, supporting the assertion could also be obtained. The level of evidence that is necessary and appropriate is a matter of judgment that depends on all available information. The appropriate “unit of account” for determining what constitutes an individual tax position, and whether the more-likely-than-not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account shall consider the manner in which the entity prepares and supports its income tax return and the approach the entity anticipates the tax authority will take during an examination. 3 Measurement Once the recognition threshold has been satisfied, the tax position must be measured to determine the amount of benefit that may be recognized in the financial statements. The tax position is measured by looking at all of the potential outcomes and assessing the probability that each will occur. The amount of benefit that may be recognized is the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. Measurement should be based on management’s best judgment given the facts, circumstances, and information available at the time, and on management’s experience with the relevant taxing authority on similar matters. Because very few tax disputes are ultimately settled in litigation, the measurement of the tax position should be based on management’s best judgment of the amount the taxpayer would ultimately accept in a settlement with the taxing authorities. In other words, if management is more than 50 percent confident that the full amount of a tax position will be allowed, then the full amount should be recognized. Subsequent Recognition, Derecognition, and Measurement If the recognition threshold is not met in the period for which a tax position is taken or expected to be taken, the benefit of the tax position should be recognized in the first interim period in which one of three conditions is satisfied: (i) the recognition threshold is met by the reporting date; (ii) the tax matter is ultimately settled through negotiation or litigation; or (iii) the statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired. Conversely, a recognized tax position must be derecognized in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination. Subsequent recognition, derecognition, and measurement should be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Subsequent changes in judgment should result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period. Effective Date and Transition FIN 48 is effective for fiscal years beginning after December 15, 2006. The Interpretation shall be applied to all tax positions upon initial adoption. Only tax positions that meet the more-likely-than- 4 not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption. The cumulative effect of applying the Interpretation shall be reported as an adjustment to net assets in the statement of financial position. Gregory M. Smith Karen Lau Director - Operations/Compliance & Fund Assistant Counsel - Tax Law Accounting

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