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JANUARY 4, 2007

FIN 48: Significant New U.S. GAAP Reporting Requirements for Uncertainty in Income Taxes

The Financial Accounting Standards Board recently issued FASB Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes, containing a number of new standards relating to the financial reporting of uncertain tax positions under U.S. GAAP.[1] As discussed below, FIN 48 imposes a more-likely-than-not threshold to the recognition of *any* financial statement benefit of a tax position taken or expected to be taken on a tax return. However, tax positions that meet this recognition threshold are then measured as the largest amount that is more likely than not to be realized. In making these significant changes to the financial reporting rules, FIN 48 creates many implementation problems and burdens and will likely cause companies to significantly overstate their ultimate tax liabilities.

Prior to the issuance of FIN 48, the evaluation of tax positions typically was limited to tax positions judged to be uncertain. The benefits of tax positions not judged to be uncertain were fully recognized in financial statements. In short, under GAAP rules previously in effect, the tax benefit of a filing position was generally recognized in financial statements in accordance with tax return reporting. Tax benefits were not offset by any valuation allowance or contingency reserve unless (1) it was more likely than not that the tax benefit would not be realized or (2) it was *probable* that the tax benefit would be challenged and disallowed by the Internal Revenue Service or another tax authority.

FIN 48 takes a much more conservative approach to the inherent uncertainty in the income tax benefits to be derived from tax positions that are taken on income tax returns. Using a benefit recognition approach, FIN 48 requires that each material tax position be evaluated using a consistent set of criteria. Only tax benefits meeting these criteria can be recognized in financial statements. **Whereas tax positions were historically presumed to be correct, companies are now required to identify and analyze each and every material tax position taken (or not taken) on every return filed (or not filed) in every jurisdiction imposing an income tax, and must establish that each such tax position will more likely than not be sustained, even when there may not be any evidence that the position will be challenged. This will cover tax issues arising from everything, including reorganizations, purchase price allocations, transfer pricing, state nexus, foreign permanent establishments, and every "tax product" purchased in any tax jurisdiction.** As such, FIN 48 significantly increases the compliance burden of all companies using U.S. GAAP.

Application of FIN 48

The application of FIN 48 to a company's tax positions creates two categories of tax benefits: "recognized tax benefits" and "unrecognized tax benefits." Recognized tax benefits are tax benefits that are recorded in the company's financial statements. Unrecognized tax benefits represent the company's potential future obligation to a taxing authority, and must be recorded as such in financial statements.

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[1] FIN 48 is effective for fiscal years beginning on or after December 15, 2006. However, as of this date, many trade and lobbying groups are actively seeking a one-year deferral in the effective date. The FASB has stated they will be considering these requests but that any delay is purely speculative.

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Under FIN 48, every company will need to identify all its material tax positions by year and by jurisdiction. Even highly certain material tax positions must at least be identified. The term "position" is broadly defined to include deductions taken (or expected to be taken), taxable income excluded or *recharacterized* (or expected to be excluded or *recharacterized*), apportionment or allocation determinations, conclusions not to file an income tax return, and conclusions that an entity or transaction (*e.g.*, a reorganization) is tax-free. Material tax positions must be identified on a jurisdiction-by-jurisdiction basis because separate computations are required for each tax jurisdiction (*i.e.*, state-by-state, country-by-country). Material tax positions must be identified in each year that remains open to assessment and collection by the relevant tax authority.[2]

After the identification and organization of material tax positions is complete, each individual tax position identified must be evaluated and documented using a two-step process:

(1) the company must determine whether it is more likely than not that the tax position will be sustained upon examination by the relevant taxing authorities based on the technical merits of the position; and

(2) a tax position that has met the more-likely-than-not recognition threshold is measured, and recorded in the company's financial statements as a recognized tax benefit, at the largest amount of benefit that is cumulatively greater than 50 percent likely to be sustained upon ultimate settlement with the tax authority.

No amount of benefit can be recognized for positions that fail to meet the recognition threshold (paragraph (1) above) – instead, the entire tax benefit provided by such positions must be reserved in its financial statements. Moreover, a tax position that meets such recognition threshold must measure the tax benefit (paragraph (2) above) based on an analysis of the distribution of potential outcomes and their related probabilities. Under FIN 48, the company must construct a probability table showing the possible outcomes for a particular tax benefit, and the individual and cumulative probabilities of each outcome occurring. FASB does not indicate where this probability data will come from, forcing companies to rely primarily on expert opinions.

A company must complete this two-step process for all material tax positions, except perhaps the most highly certain of them. Accordingly, a company may be faced with completing the analysis for hundreds of such tax positions. The detailed assessment of the probability of success and the measurement of the amount expected to be sustained will require explicit documentation, expert legal and accounting advice, and will often necessitate an update of current legal opinions on preexisting tax positions. It is unclear how a company can attribute probabilities of incremental success on audit, even with such data.

Once the identified tax positions have been evaluated and measured for each open tax year and jurisdiction, a company must make appropriate entries in its financial accounting records. The difference between the amount taken or expected to be taken on a tax return for the current year and the amount of tax benefit recognized in financial statements is equal to the amount of unrecognized tax benefits. A liability is generally recorded for the amount of unrecognized tax benefits. **This liability is not considered to be a component of deferred taxes or tax assets and must be classified separately from other tax balances.** In addition, a company must accrue interest on unrecognized tax benefits in a manner consistent with the tax law (*i.e.*, the entity must assume that the benefit will be disallowed in full on audit and must accrue interest on the resulting income tax deficiency).

In an effort to achieve increased transparency of tax exposures, FIN 48 also requires certain disclosures in a company's financial statements, including (1) a discussion of tax positions management expects to change significantly within the next 12 months, (2) the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate and (3) a qualitative roll-forward of the worldwide aggregate amount of unrecognized tax benefits. The reconciliation of this aggregated number must include items such as the effects

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[2] For U.S. federal income tax purposes, a tax year generally remains open to assessment and collection for 3 years after the later of the due date for filing a tax return or the date on which the taxpayer files its return.

of new tax positions taken during the year, changes in assessments of prior-period positions, the effect of settlements with taxing authorities, and reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

In short, FIN 48 represents a significant shift in the way tax contingencies are evaluated and reported. The new criteria for recognition and measurement of tax benefits imposed by FIN 48 will likely force companies to overstate their tax liabilities, add significant complexity to the recordation of book and tax differences, create confusion regarding the differing standards for income tax contingencies versus other similar contingencies, and potentially cause financial reporting to influence tax reporting.

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